S
808

PREM 19/1016

North Sea Oil Prices

Heavy Fuel Oil Prices.

ENERGY

January 1980

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
9.1.80		20.10.82					
17.1.80		11.2.82					
21.1.80		22.3.82					
5-2-80		23.12.82					
6.2.80		27.1.83					
11.4.80		31.1.83					
15.11.80							
18.4.80		17.2.83					
29.4.80		24.2.83					
[illegible].5.80		3.3.83					
23-12-80.		9.3.83					
		12.3.83					
22.5.81		16.3.83					
4.6.81		18.3.83					
5-6-81		23.3.83					
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		22.6.83					

PREM 19/1016

Dd 533270 5M 2/78 8362633 JET

- Pt Ends -

PART 1 ends:-

Note of Mtg - S/S Energy / M/Energy 22/6

PART 2 begins:-

D. Pascall to AT 7/10

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(83) 11th Meeting, item 4	24/03/1983
CC(83) 6th Meeting, item 4	24/02/1983
CC(83) 5th Meeting, item 4	17/02/1983
CC(83) 2nd Meeting, item 4	27/01/1983
CC(82) 5th Meeting, item 2	11/02/1982

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed J. Gray Date 27/3/2013

PREM Records Team

Mr. [illegible] to see.

A.J.C. 27/6

SOS/R 8A/83

NOTE OF THE SECRETARY OF STATE'S MEETING WITH DR MANA SAID AL OTAIBA, UAE MINISTER OF PETROLEUM AND MINERAL RESOURCES, ON 22 JUNE 1983

Also present: Mr Guinness
Mr West

After the initial courtesies, the Secretary of State said that he was anxious that Dr Otaiba and he should get to know each other and he invited Dr Otaiba to call on him or telephone whenever he wished. Dr Otaiba said that he hoped the Secretary of State would visit the Gulf and the UAE in particular.

The Secretary of State asked about the oil price. Dr Otaiba replied that the MMC meeting in Paris had seen the situation improving gradually - OPEC's share of the market was now 17 mbpd - and, so long as the London quotas were respected and spot sales or discounting avoided, the improvement would continue, perhaps to 19 mbpd by the fourth quarter. However, the market remained weak and OPEC members should not be too impatient about capitalising on rising demand. The MMC had again asked him to call on the UK, the Egyptians and the Omanis, and the Algerian minister on the Russians and the Chinese who were now exporting about 400,000 b/d. Mr Guinness asked about the Nigerians and Dr Otaiba replied that their production was now exceeding their quota on a daily basis, but not as an average for the quarter as a whole. He had nevertheless telexed Dikko before the MMC meeting, asking him to be careful.

The Secretary of State expressed his hope that the price would be successfully stabilised. He found it amusing that the sharp increases in the OPEC price of 1973 and 1979 had been described as a major disaster for the western world and now that there was a prospect of a sharp fall in the price, that too was seen as a disaster. Dr Otaiba said that people in the US were worried about a price collapse and he had told them that they should therefore co-operate with OPEC. He found it amusing that those OPEC members who had been most outspoken in their criticisms of the Gulf producers for not raising the price faster in the past had also been the main contributors to the downward pressure on prices when the market had weakened.

The Secretary of State asked whether Nigeria was not the weakest link in OPEC's chain. Dr Otaiba replied that they had come under the severest market pressure but Libya and Iran had been the worst behaved members. In his view, though, the Nigerians made too much of the link between their oil and the North Sea's. Mr Guinness pointed out that North Sea spot prices were now up to and in some cases above term prices and Dr Otaiba asked if therefore the UK would be raising its prices. The Secretary of State replied that his objective was price stability.

He said that he hoped to keep in close touch with the Gulf States' thinking and to continue the good relations his predecessor had developed with the oil ministers in the region. Dr Otaiba asked for the Secretary of State's views on a dialogue between producers and consumers. The Secretary of State replied that he was nervous about such a dialogue because of the difficulty in meeting the expectations it would create. All necessary conversations could take place privately without a formal dialogue - after all, no doors were closed to Dr Otaiba and he had no need of a great public stage. Mr Guinness added that he doubted whether the fruitful discussions between OPEC ministers and the previous Secretary of State during OPEC's London meeting could have occurred in the context of a formal dialogue. Dr Otaiba agreed that it was necessary to proceed with caution.

He said that Shaikh Sayed [Zaid] sent his congratulations to the Prime Minister on her election victory and looked forward to a continuation of his special relationship with her Government, in all fields not just that of energy. He also said that he wished simply to mention to the Secretary of State, as a friend, Shaikh Sayed's desire to see Mahdi Tajir reappointed as ambassador in London.

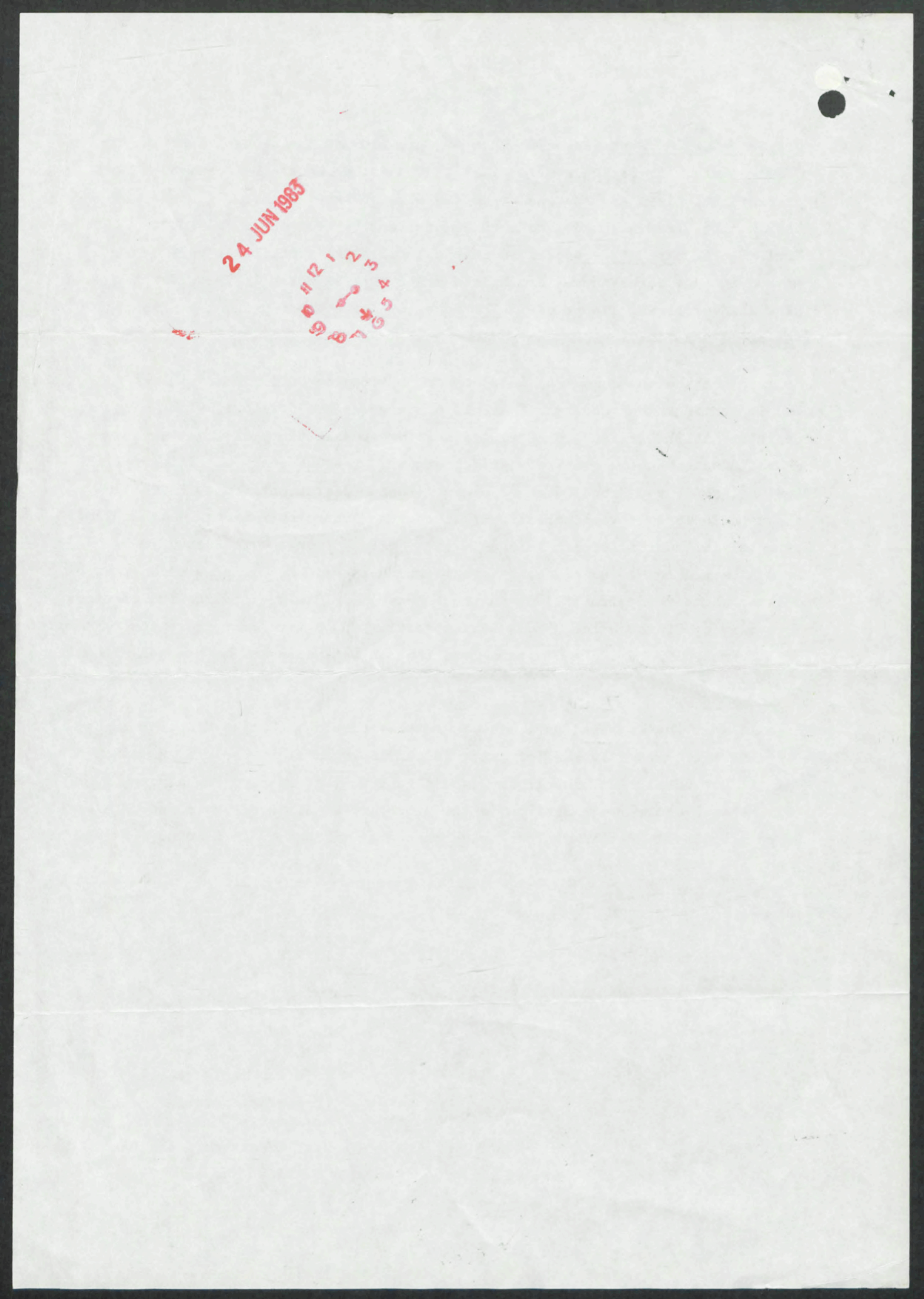
J D WEST
PS/Secretary of State
Room 1237
Ext 6402
23 June 1983

cc PS/Minister of State
PS/PUS
Mr Guinness
Mr Wiggins
Mr Fremantle
Ms Boys
Mr Higson

PS/Prime Minister

PS/Foreign Secretary
Mr Adams, FCO

H.M. Ambassador, Abu Dhabi


24 JUN 1983

SOS/R 73/83

NOTE OF THE SECRETARY OF STATE'S MEETING WITH DR MANA SAID AL-OTAIBA MINISTER FOR ENERGY, UNITED ARAB EMIRATES, ON 18 APRIL 1983

Present: Secretary of State — Dr Otaiba

Mr Guinness — Private Secretary

Mr West

Dr Otaiba said that his Monitoring Committee had been encouraged by the market's response to OPEC's agreement, and had seen no signs of its being eroded. The Committee felt that the UK's moderate price cut, and Nigeria's response, had been important contributors to the market's confidence. It had recommended that OPEC's long-term strategy committee should also meet to further dialogue with the oil consuming countries. It intended that contacts with non-OPEC producers should be extended beyond the UK, Mexico and Norway: the Algerians had been asked to speak to the Russians, who had behaved particularly badly by dumping up to 1½ mbpd on the spot market; and Egypt, Oman and Brunei were also on the list.

Monitoring was proving effective. He had been able to keep Iran in line when the Majlis had rejected the London agreement - Iran was producing less than 2.4 mbpd and selling at $28.

The Nigerians had asked to attend the Committee meeting in London and were quite relaxed - they were producing 800,000 b/d and expected soon to reach 1 million. The main problem was with Libya because of their differential with Nigeria. He was trying to arrange a meeting, though not in Tripoli. The Libyans were still processing oil in the Bahamas and doing barter deals with the Russians who then sold the oil in Rotterdam.

The next meeting of the Committee would be in Paris in June. He had seen Secretary Hodel in Washington the previous week and had asked him to co-operate with OPEC. Hodel had claimed to be preoccupied with gas deregulation and had asked what was the UK's position. The Secretary of State said that the market had definitely become firmer, which was gratifying. However, he had seen press reports suggesting that the UK had agreed with OPEC to control production. As Dr Otaiba knew, this was misleading and North Sea production would be the same in 1983 as in 1982 without Government intervention. Dr Otaiba said that he had said publicly in the US that the UK, Mexico and Norway had all told OPEC their production would not increase in 1983. He had gone on to say that it was not

OPEC's concern whether this resulted from technical or political factors - OPEC was concerned only that non-members should not capitalise on their production cuts. He always sought to avoid talking in too much detail about specific non-members and had told the press conference following his Committee meeting that non-OPEC producers were all supporting OPEC in their own way. The Secretary of State said that the last formulation was the literal truth and that it was important for the UK's position to be clearly understood.

He noted that the next few months would be critical for the oil price. Dr Otaiba agreed and asked whether North Sea prices were likely to be cut again. Of course, no one cut their prices unless forced to do so by the market. The Secretary of State agreed in turn and added that BNOC had the additional restraint of being obliged to offer its suppliers the best price the market would bear. It had now proposed that its March prices should run for the second quarter and, although its customers were being cautious, the signs were that this price would hold. At any rate, there was a good chance of its doing so provided OPEC stuck to its agreement.

Dr Otaiba said that Sheikh Zaid sent the Prime Minister his greetings, had appreciated her informal message and welcomed co-operation between the UK and the UAE. Since this was not a formal message, Dr Otaiba had not asked to see the Prime Minister but was at her disposal until Friday if she wished to see him.

The Secretary of State said that he was glad to see Dr Otaiba again and hoped that their informal contacts would continue. Dr Otaiba said that the Secretary of State was welcome in the UAE at any time but before 24 May would be most convenient.

J. D.

J D WEST
PS/Secretary of State
Rm 1237
Ext 6402
19 April 1983

cc PS/Minister of State
PS/PUS
Mr Guinness
Mr Wiggins
Mr Morphet
Mr Fremantle
Ms Boys
Mr Higson

PS/Prime Minister

PS/Foreign Secretary

10 DOWNING STREET

Prime Minister

We should hear over the weekend whether Dr. Otaiba will be available to call on you at 11.00 on Monday.

2. Mr. Lawson would like to attend if he does.

A.J.C. 15/4

Foreign and Commonwealth Office

London SW1A 2AH

15 April 1983

Dear John,

Visit of UAE Minister of Petroleum: Dr Mani al Otaiba

Thank you for your letter of 12 April. Dr Otaiba is expected to arrive from Washington late this evening, 15 April. We have been unable to ascertain whether he will be bringing a message from Shaikh Zaid. We will try tomorrow to establish this, and whether he wants to see the Prime Minister, and let you know as soon as possible. In the meantime, you may like a short note on the background, and some points which the Prime Minister might make, agreed with the Department of Energy.

Dr Otaiba's main purpose in London is to chair the meeting of the OPEC Monitoring Committee here on 18/19 April which will check how individual OPEC members are sticking to the price and production agreements made at the OPEC meeting which ended here on 14 March.

Our impression is that the OPEC states are generally abiding by the agreement, and this is reflected in the present relative stability of the market. The situation has been helped by BNOC's modest price changes for North Sea oil. Though the companies have not yet agreed formally that the March price should also apply to April, BNOC should be able to hold March prices in April and beyond if market confidence holds. The gap between official prices and the spot market has closed considerably over the last week. The key to stability is that OPEC countries should observe the discipline of their production and pricing agreement: BNOC pricing policy can have only a marginal effect.

The Prime Minister may wish to stress that BNOC's pricing moves were carefully judged with the intention of helping stabilise the oil market.

/We have

We have heard reports from our Embassy in Abu Dhabi that the UAE have taken on the task of plugging the massive oil leak spilling from an Iranian offshore oil field, although there are other reports that the Gulf countries have been unable to agree with Iran and Iraq how this should be tackled. The Prime Minister may wish to enquire about this and if appropriate to express hopes for the success of the operation. She might also remind Dr Otaiba that BP (who are world experts in pollution control work) are standing by to help.

/ I also enclose a personality note and, in case
/ Dr Otaiba raises other issues, a short brief covering bilateral relations, Arab/Israel and Iran/Iraq.

I am copying this letter to Julian West at the Department of Energy.

Yours ever
John Holmes

(J E Holmes)
Private Secretary

A J Coles Esq
10 Downing Street

CALL ON THE PRIME MINISTER BY DR OTAIBA, UAE MINISTER OF PETROLEUM

LINE TO TAKE

Bilateral

1. Mr Pym very pleased with visit last week to UAE. Useful and timely discussions on Arab/Israel and Iran/Iraq.

2. Delighted with signature of Hawk contract in January. Appreciate your support for this.

Iran/Iraq

3. We are deeply concerned about the war. We have studied proposals from some GCC states (but not UAE) about further action by the UN. Share your doubts about effectiveness of UN Security Council.

Military Situation

4. Small scale Iranian offensive launched on 10 April may have regained small amount of Iranian territory. Iraqis well equipped to hold, though probably taken by surprise. Fighting continues.

Other Mediation Attempts

5. Algerians inactive. Will there be follow-up to NAM initiative, e.g. by the Indians? Do we know Iranian terms for settlement?

Arab/Israel

6. Breakdown of Hussein/Arafat discussions a setback. But Reagan plan still offers only realistic starting point for negotiations. Stalemate in no-one's interests.

/7.

7. <u>Jordanian statement</u> leaves door open to further talks. Vigorous effort needed from all sides if opportunity to be seized.

8. <u>European role</u> still active. Prevent polarisation and encourage compromise.

DR MANA SAID AL OTAIBA

UAE Minister of Petroleum and Mineral Resources.

Born 1946 in Abu Dhabi to a leading merchant family. Educated at Baghdad and Cairo Universities.

A favourite of the President of the UAE and Ruler of Abu Dhabi, Shaikh Zaid, to whom he owes much of his position.

Called on Prime Minister in February 1981, but was not very impressive. Has since grown in stuture and is now a leading OPEC figure, taking a 'moderate' line on pricing. The Prime Minister also had talks with him during her visit to the UAE in April 1981.

He has a strong interest in foreign affairs, which has become more noticeable since the resignation in April 1980 of the UEA Foreign Minister and the absence of an appointed successor to him.

He speak good English, which he studied in the UK, and has been helpful to British interests, eg over the sale of Hawk.

CALL ON THE PRIME MINISTER BY DR OTAIBA, UAE MINISTER OF PETROLEUM

BACKGROUND

Bilateral

1. Mr Pym visited the UAE from 10-12 April. He had discussions with the President of the UAE, Shaikh Zaid, with his eldest son and Heir Apparent, Shaikh Khalifa, and with the Head of the Presidential Court, Shaikh Surour.

2. Relations are good. No bilateral problems. The signing of the Hawk contract in January this year (Dr Otaiba was an influential supporter of this) has given fresh impetus to our defence sales effort. There is a possibility of further Hawk sales.

Military Situation

3. Iranian attack on 10 April seems to have surprised the Iraqis. Initial advances recaptured small amounts of Iranian territory, but these advances have been halted. Fighting continues. Each side has roughly 100,000 troops in the area, but only small numbers have been engaged so far. Iranian intention probably to keep Iraqi military on the hop.

UN Action

4. The Prime Minister has recently received letters from the Amirs of Bahrain, Qatar and Kuwait and from King Fahd of Saudi Arabia, asking for further action by the permanent members of the UN Security Council to bring the conflict to an end. The UAE has not taken part in this GCC exercise, and it is clear from Mr Pym's recent visit that the UAE shares our view that further Security Council action will only serve

/to irritate

to irritate the Iranians to no good effect. Further action by the UN should await clear signal from the Iranians that they are ready for serious negotiations.

5. The Prime Minister's reply to the Amir of Bahrain emphasised our willingness to support any realistic efforts aimed at achieving negotiated settlement. Our replies to the other letters will be along similar lines.

6. We are in touch with the Americans about the possibility of a new initiative arising from the NAM which would involve Mrs Ghandi and the UN Secretary-General.

UAE Attitude to the War

7. UAE enjoys better relations with Iran than do some of her Gulf neighbours, and is more anxious than others to maintain an even-handed attitude to any international activity aimed at bringing the two sides together.

Arab/Israel

8. The UAE take their cue on Arab/Israel issues from the Saudis. They support a political process based on the Fez principles, but will not get out in front of the Saudis, eg in support for King Hussein. The President of the UAE, Sheikh Zaid, told Mr Pym during the latter's visit on 10 April that Arafat had to consult widely within the Palestinian movement before he could agree to a joint approach with the Jordanians: he should not be pressed too hard.

9. King Hussein intended the Jordanian Government statement to be a 'sharp shock' to generate new thinking both within the PLO and Washington. It avoided closing the door on further Jordanian/PLO discussions, but Jordan will wait for the PLO to take the next move. Arafat has since expressed interest in further dialogue.

10. The Ten have not yet considered in detail the implications of recent developments for European policy. But if the US show signs of disengaging, we shall have an enhanced role to play in maintaining confidence in all sides in negotiated solutions.

10 DOWNING STREET

From the Private Secretary 12 April 1983

VISIT OF UAE MINISTER OF PETROLEUM

Thank you for your letter of 8 April. If Dr. Otaiba brings a message to the Prime Minister from the Ruler of Abu Dhabi, the Prime Minister would be able to receive him at 11.00 a.m. on Monday, 18 April.

I am copying this letter to Julian West (Department of Energy).

R. B. Bone, Esq.,
Foreign and Commonwealth Office.

CONFIDENTIAL

Prime Minister

Agree to see U.A.E. Minister of Petroleum at 11.00 a.m. on Monday, 18 April?

A.J.C. 11/4

Foreign and Commonwealth Office

London SW1A 2AH

8 April 1983

Yes

Dear John,

VISIT OF UAE MINISTER OF PETROLEUM

In his telegram no 93 (copy attached) HM Ambassador at Abu Dhabi reports that the UAE Minister of Petroleum, Dr Mani Al Otaiba, is to visit London briefly on his way to the United States, returning on 15 April for a longer stay. He is expected to chair an OPEC monitoring committee in London from 18 April onwards.

Dr Otaiba may bring with him a reply from the Ruler of Abu Dhabi, Shaikh Zaid, to the message which the Prime Minister sent to a number of Gulf Rulers on 26 March. He has said that if he does bring such a message, he would like to be able to deliver it personally.

We see considerable advantage in the Prime Minister seeing Otaiba if he brings a message and if a suitable time can be arranged, perhaps between 15 and 18 April. A meeting would demonstrate the importance we attach to the channel of communication between the Prime Minister and Shaikh Zaid, both on account of our broader relations with Abu Dhabi and because we may conceivably need to use it again if BNOC make a further move on oil prices in the next few weeks and we are obliged once more to seek Abu Dhabi's understanding.

Though Sheikh Zaid's message is unlikely to contain much of substance, Dr Otaiba for his part would be in an ideal position to give an overall impression of thinking, particularly in the Gulf States, on oil prices. He also appreciates the British position over North Sea oil prices (he would probably discuss any detailed issues separately with Mr Lawson if, as we hope, an opportunity could be found).

I am copying this letter to Julian West at the Department of Energy.

Yours ever,

Roger Bone

(R B Bone)
Private Secretary

A J Coles Esq
10 Downing Street

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GRS 270

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FM ABU DHABI 070720Z APR 83

TO IMMEDIATE FCO

TELEGRAM NUMBER 93 OF 7 APRIL 83

RPTD FOR INFO TO DUBAI .

MY TELNO 79:

UAE MINISTER OF PETROLEUM.

1. THE UAE MINISTER OF PETROLEUM CONFIRMED TO US YESTERDAY HIS INTENTION TO SPEND TWO DAYS IN LONDON ON HIS WAY TO THE UNITED STATES. HE LEAVES FOR LONDON TONIGHT 7 APRIL. HE INTENDS TO RETURN TO LONDON ON 15 APRIL BEFORE HOLDING THE OPEC MONITORING COMMITTEE MEETING THERE ON 18 APRIL.

2. OTAIBA ALSO TOLD US THAT HE HAD PREPARED A REPLY FROM SHAIKH ZAID TO THE PRIME MINISTER'S MESSAGE ABOUT OIL PRICES (FCO TELNO 55 TO KUWAIT) WHICH HE HOPED WOULD BE READY FOR HIM TO BRING: IF SO HE HOPED TO BE ABLE TO DELIVER IT TO THE PRIME MINISTER HIMSELF. THE MESSAGE HE SAID CONTAINED NOTHING CONTROVERSIAL, BUT RATHER EXPRESSED APPRECIATION AND UNDERSTANDING OF HMG'S ATTITUDE.

3. AS TIME WILL BE SHORT ON HIS OUTWARD VISIT, WHEN HE WILL IN ANY CASE BE HAVING MEDICAL TREATMENT, IT WILL NO DOUBT BE EASIER TO CATCH OTAIBA ON HIS RETURN TO LONDON FROM THE US. HE WILL BE STAYING EITHER AT HIS GROSVENOR SQUARE FLAT (TELEPHONE NUMBER WITH THE DEPARTMENT) OR AT A NEW ONE IN CARLOS PLACE (TEL 493 4925/6 REPEAT 493 4925/6).

4. IF HE IS CARRYING ZAID'S MESSAGE AND THERE IS ANY CHANCE OF HIS SEEING THE PRIME MINISTER THIS WOULD OF COURSE BE GREATLY APPRECIATED BY HIM, AND I THINK ALSO BY ZAID. IF THE PRIME MINISTER CANNOT RECEIVE OTAIBA, I HOPE THAT IN ANY CASE AN APPOINTMENT CAN BE ARRANGED WITH MR LAWSON, WHO AMONG OTHER THINGS MIGHT WISH TO SOUND OTAIBA ABOUT A VISIT HERE.

WALKER

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TO IMMEDIATE FCO
TELEGRAM NUMBER 93 OF 7 APRIL 83

RPTD FOR INFO TO DUBAI .

MY TELNO 79:

UAE MINISTER OF PETROLEUM.

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X) 4. IF HE IS CARRYING ZAID'S MESSAGE AND THERE IS ANY CHANCE OF HIS SEEING THE PRIME MINISTER THIS WOULD OF COURSE BE GREATLY APPRECIATED BY HIM, AND I THINK ALSO BY ZAID. IF THE PRIME MINISTER CANNOT RECEIVE OTAIBA, I HOPE THAT IN ANY CASE AN APPOINTMENT CAN BE ARRANGED WITH MR LAWSON, WHO AMONG OTHER THINGS MIGHT WISH TO SOUND OTAIBA ABOUT A VISIT HERE.

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TO IMMEDIATE FCO
TELEGEGRAM NUMBER 262 OF 5 APR 83
AND TO IMMEDIATE JEDDA AND RIYADH
PRIORITY TO WASHINGTON, OSLO, KUWAIT, DOHA, ABU DHABI, MUSCAT, BAGHDAD, BAHRAIN, AND BIS TEHRAN

SAVING TO BEIRUT, JAKARTA, CARACAS, MEXICO CITY, TRIPOLI AND ALGIERS.

MIPT. OIL PRICES.

1. FOLLOWING IS TEXT OF DIKKO'S REPLY.

QUOTE

DEAR MR. LAWSON,

THANK YOU VERY MUCH FOR YOUR MESSAGE WHICH WAS ILLUMINATING ON MANY ASPECTS OF BRITISH GOVERNMENT OIL POLICY. I READ YOUR LETTER

ON MANY ASPECTS OF BRITISH GOVERNMENT OIL POLICY. I READ YOUR LETTER .

VERY CAREFULLY INDEED AND BELIEVE THAT IT WOULD BE HELPFUL IF I MADE SOME ADDITIONAL COMMENTS ON THE PRESENT AND FUTURE OIL SITUATION IN ADDITION TO THE PRESS STATEMENT THAT OUR GOVERNMENT HAS ISSUED.

2. WE ARE HAPPY TO NOTE THAT THERE IS AN INCREASING SENSE AMONGST ALL PRODUCERS THAT THE PROBLEM OF THE OIL MARKETS ARE NOT TO BE LEFT TO OPEC ALONE. THIS APPEARS TO BE A SENTIMENT THAT BOTH OF US HAVE SHARED AND EXPRESSEDGON SEVERAL OCCASIONS. WE THEREFORE REGARD YOUR RECENT PRICE ACTIONS AS AN ATTEMPT TO RECOGNISE THE INEVITABLE RELATIONSHIP BETWEEN OPEC AND NON-OPEC PRICES.

3. WE DO NOTE THAT BRENT AND FORTIES ARE NOT THE ONLY CRUDES PRODUCED BY THE NORTH SEA FIELDS AND WHEN ALL CRUDES ARE CONSIDERED, TWO-THIRDS OF BRITISH OUTPUT HAS DROPPED BY 75C AND ONE-THIRD OR LESS BY 50C. IN OUR VIEW, WHILE THERE IS PARITY BETWEEN BRENT AND SOME NIGERIAN CRUDES, WE REALLY FIND IT HARD TO JUSTIFY PRICES AS FORTIES AND NINIAN FOR EXAMPLE. WE HAVE NEVERTHELESS ACCEPTED THE SITUATION FOR THE PRESENT IN THE INTEREST OF STABILITY. AS I AM SURE YOU ARE AWARE WHILE WE ARE QUITE NATURALLY INTERESTED IN PROMOTING STABILITY, WE ARE EQUALLY CONCERNED WITH THE NATURE AND BASIS OF SUCH STABILITY.

4. WE NOTE THE POINT THAT YOUR PRICES ARE ONLY GOOD FOR MARCH. IT WOULD BE MOST UNFORTUNATE FOR US ALL IF OUR FLEXIBILITY REGARDING OUR PRESENT ACTIONS LED TO ANY MISUNDERSTANDING AS TO HOW WE WOULD REACT TO ANY PRICE CUTS IN APRIL OR THEREAFTER.

5. WE ALSO NOTE YOUR VIEWS AS TO THE IMPORTANCE OF PRODUCTION LEVELS IN THE OIL MARKETS. IN THIS SPIRIT YOU HAVE INFORMED US THAT YOUR PRODUCTION LEVELS IN 1983 WILL NOT EXCEED THOSE OF 1982, AND THAT YOU BELIEVE THAT THERE SHOULD BE ENOUGH SPACE IN THE MARKET FOR BOTH NIGERIAN AND BRITISH CRUDES. WE SHARE YOU VIEWS ON PRODUCTIO
N
LEVELS. IT IS FOR THIS REASON THAT WE TOOK A DECISION TO ACCEPT VOLUNTARY PRODUCTION CUTBACKS BELIEVING THAT THIS WOULD HELP ELIMINATE THE GLUT IN THE MARKET AND THAT THIS WOULD BE BETTER THAN AN IMPOSED CUTBACK EFFECTED VIA A DAMAGING PRICE WAR. WE BELIEVE IT IS A BASIC BUSINESS REALITY THAT IN A SITUATION OF WIDESPREAD EXCESS CAPACITY, IT IS SIMPLY NOT EUITABLE FOR ONE OR TWO PRODUCERS TO BE PRODUCING AT FULL CAPACITY WHILE OTHERS ARE PRODUCING AT HALF CAPACITY WHEN BOTH PARTIES HAVE COMMON INTEREST IN MAINTAINING AN AGREED PRICE LEVEL.

PRODUCING AT HALF CAPACITY WHEN BOTH PARTIES HAVE COMMON INTEREST IN MAINTAINING AN AGREED PRICE LEVEL.

6. WE ARE AWARE OF YOUR OWN OIL ARRANGEMENTS AS CONTAINED IN THE ''PETROLEUM AND SUBMARINE PIPELINES ACT 1975'' AND OF THE NATURE OF THE ASSURANCES GIVEN BY SUCCESSIVE BRITISH MINISTER. WE ARE SATISFIED THAT YOU HAVE SUFFICIENT POWERS TO PROTECT OUR COMMON INTERESTS WHICH LIE IN AVOIDING A PRICE WAR.

7. WE ARE ALSO CONCERNED LIKE YOU ABOUT STABILITY. WE WILL THEREFORE BE WATCHING THE SPOT MARKET. YOU WILL NOT DOUBT RECOGNISE THAT THE GREATEST CAUSE OF A DETERIORATION IN THE SPOT MARKET LIES IN INCREASED SPOT SALES. NIGERIA WILL NOT DISPOSE OF ITS CRUDE OIL IN THIS MANNER BECAUSE IT IS DESTABILISING. WE ARE CONFIDENT THAT YOU HAVE A SIMILAR INTEREST AND WILL NOT BE DUMPING CRUDE AND THEREBY SETTING THE STAGE FOR ANOTHER ROUND OF PRICE CUTS.

8. I WOULD LIKE TO END BY THANKING YOU FOR YOUR LETTER. I HOPE AND TRUST THAT THE SPIRIT OF PRIOR NOTIFICATION WHICH HAS DEVELOPED OVER THE PAST FEW MONTHS WILL CONTINUE, FLOURISH AND HOPEFULLY DEVELOP INTO PRIOR CONSULTATIONS.

THANK YOU.

YOURS SINCERELY,

(Y.A. DIKKO, O.F.R.)
SPECIAL ADVISER TO THE PRESIDENT
ON PETROLEUM AND ENGERY

FCO PLEASE PASS SAVING ADDRESSEES

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Prime Minister

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GRS 700
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FM LAGOS 051400Z APR 83
TO IMMEDIATE FCO
TELNO 261 OF 5 APRIL
AND TO IMMEDIATE JEDDA, RIYADH
PRIORITY WASHINGTON, OSLO, KUWAIT, DOHA, ABU DHABI, MUSCAT,
BAGHDAD, BAHRAIN, BIS TEHRAN.

AND SAVING TO JAKARTA, CARACAS, MEXICO CITY, TRIPOLI, ALGIERS.

MT

MY TELNO 258: OIL PRICES

SUMMARY

1. THE NIGERIAN GOVERNMENT, WHILE ACCEPTING BNOC PRICE CUTS, HAS RESERVATIONS ABOUT THE CHANGE IN THE MARKER CRUDE AND IS CONCERNED ABOUT THE LACK OF ANY INDICATION THAT NORTH SEA OIL PRODUCTION MIGHT BE CONTROLLED. BUT THEY ARE HOPEFUL THAT THE MARKET HAS NOW STABILISED AT LEAST FOR THE SHORT TERM.

2. I CALLED ON DIKKO AT MIDDAY TO RECEIVE HIS REPLY TO MR LAWSON'S MESSAGE (TEXT IN MIPT). DIKKO SAID THAT ALTHOUGH THE NIGERIANS HAD AGREED NOT TO REACT TO THE LATEST BNOC PRICE CUTS, THEY HAD RESERVATIONS ON TWO POINTS. FIRST, THE CHANGE IN THE MARKER CRUDE FROM FORTIES TO BRENT, WHICH MEANT IN PRACTICE THAT ONLY 1/3 OF BRITISH OIL WAS PRICED THE SAME AS THE NIGERIAN MARKER, WHILE 2/3 WAS 25 CENTS CHEAPER. (I EXPLAINED THAT BRENT WAS NOW THE MOST WIDELY TRADED CRUDE AND WAS PARTICULARLY IMPORTANT IN SALES TO USA.) WHILST THE DIFFERENTIAL IN TRANSPORTATION COSTS WAS MARGINAL IN USA, IT LEFT NIGERIA AT A DISADVANTAGE VIS A VIS BNOC IN EUROPE (I POINTED OUT THAT MOST NIGERIAN EXPORTS TO EUROPE WERE OF FORCADOS, WHICH WAS 75 CENTS CHEAPER THAN THE CHEAPEST BRITISH CRUDE). ALTHOUGH THEY HAD ACCEPTED THE PRESENT SITUATION HE WARNED THAT IF THERE WERE A FURTHER PRICE REDUCTION, THE NIGERIANS MIGHT ALIGN THEIR MARKER WITH THE CHEAPEST BRITISH GRADE RATHER THAN WITH BRENT.

3. SECONDLY, THE ASSURANCE THAT BRITISH NORTH SEA PRODUCTION WOULD NOT INCREASE IN 1983 OVER 1982 DID NOT GO FAR ENOUGH. IT STILL LEFT THE NORTH SEA PRODUCING AT FULL CAPACITY WHILE NIGERIA HAD HAD TO CUT BACK TO 2/3 CAPACITY. HE RECOGNISED THE PRESENT CONSTRAINTS ON THE BRITISH GOVERNMENT BUT STILL FELT THAT HMG HAD THE POWER TO ALTER THE SITUATION IF IT SO WISHED.

4. I ASKED HOW HE THOUGHT THE MARKET WAS RESPONDING TO THE BNOC CUT AND THE NIGERIAN RESPONSE. DIKKO SAID IT APPEARED TO BE FIRMING UP, WITH REFINED PRICES NOW DOLLARS 1.50 OR EVEN

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/ DOLLARS

DOLLARS 2 ABOVE THE OFFICIAL CRUDE PRICES. WE WOULD HAVE TO WAIT A WEEK OR SO AFTER THE RETURN FROM HOLIDAYS TO GET A CLEARER PICTURE. BUT HE THOUGHT THAT THE MARKET HAD GOT THE MESSAGE THAT THERE WAS NOW A UNDERSTANDING BETWEEN OPEC AND NON-OPEC PRODUCERS AND THAT THERE WAS NO LONGER ANY POINT IN HOLDING ON IN THE HOPE OF FURTHER PRICE CUTS.

5. I ASKED WHETHER HE THOUGHT ALL OPEC MEMBERS WOULD ABIDE BY THE RECENT AGREEMENT ON PRODUCTION QUOTAS. DIKKO SAID HE BELIEVED THEY WOULD. EVEN LIBYA AND IRAN HAD NOW COME TO UNDERSTAND THAT DISCOUNTING, BARTER AND SIMILAR DEVICES HAD THE EFFECT OF DRIVING PRICES DOWN TO EVERYONE'S DISADVANTAGE. HE UNDERSTOOD THAT LIBYA HAD NOW ABANDONED OFFSHORE REFINING AND BARTER DEALS, AND HE THOUGHT THAT EVEN IRAN WOULD NOW STAY IN LINE. THERE HAD BEEN A TREMENDOUS CHANGE IN THE LAST YEAR OR SO, AND NO SINGLE OIL PRODUCER WAS NOW INDISPENSIBLE. EVEN IF SAUDI ARABIA WERE TO SHUT DOWN COMPLETELY, THE AFRICAN PRODUCERS BETWEEN THEM COULD, IN THE PRESENT DEMAND SITUATION, EASILY FILL THE GAP. LARGE PRICE INCREASES SUCH AS THOSE CAUSED BY THE IRAN REVOLUTION AND IRAN-IRAQ WAR WERE THEREFORE A THING OF THE PAST. SHORT OF AN ALMOST UNIMAGINABLE MAJOR CONFLAGRATION INVOLVING SEVERAL GULF STATES, THE PROSPECT FOR THE FORESEEABLE FUTURE WAS AN EXCESS OF PRODUCTION CAPACITY WHICH WOULD REQUIRE RESTRAINT AND COOPERATION FROM ALL PRODUCERS.

6. DIKKO SAID HIS MAIN CONCERN WAS RATHER THE PROSPECT OF SPOT MARKET SALES BY BNOC BECAUSE OF ITS OBLIGATION TO BUY FROM PRODUCERS WHETHER OR NOT IT HAD ANY CUSTOMERS. HE THEREFORE CAME BACK TO THE NEED FOR THE BRITISH GOVERNMENT TO TAKE THE NECESSARY POWERS TO LIMIT PRODUCTION IN THE NORTH SEA AS NECESSARY IN ORDER TO MAINTAIN PRICE STABILITY.

7. IN CONCLUSION DIKKO SAID HE HAD BEEN VERY GLAD TO RECEIVE MR LAWSON'S MESSAGE. ANOTHER MAJOR CHANGE IN THE LAST YEAR HAD BEEN THE IMPROVED UNDERSTANDING BETWEEN NIGERIA AND BRITAIN AS A RESULT OF DIALOGUE BETWEEN THE OIL COMPANIES AND THE GOVERNMENTS. HE VERY MUCH HOPED THAT THIS DIALOGUE WOULD CONTINUE. I SAID THAT I WAS SURE THAT MR LAWSON SHARED THIS HOPE.

/ 8. MR LAWSON

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3. MR LAWSON MAY THINK IT APPROPRIATE TO ACKNOWLEDGE DIKKO'S UNUSUALLY LENGTHY RESPONSE AND TO SAY SOMETHING IN RECOGNITION OF NIGERIA'S UNEXPECTEDLY FORTHCOMING UNDERSTANDING OF OUR POSITION. NIGERIA'S MODERATE AND WELCOME REACTION SEEMS NOT TO HAVE BEEN ANTICIPATED BY HER OPEC PARTNERS, AS RECENT TELEGRAMS INDICATE.

FCO PLEASE PASS SAVING ADDRESSEES.

BROWN

[REPEATED AS REQUESTED]

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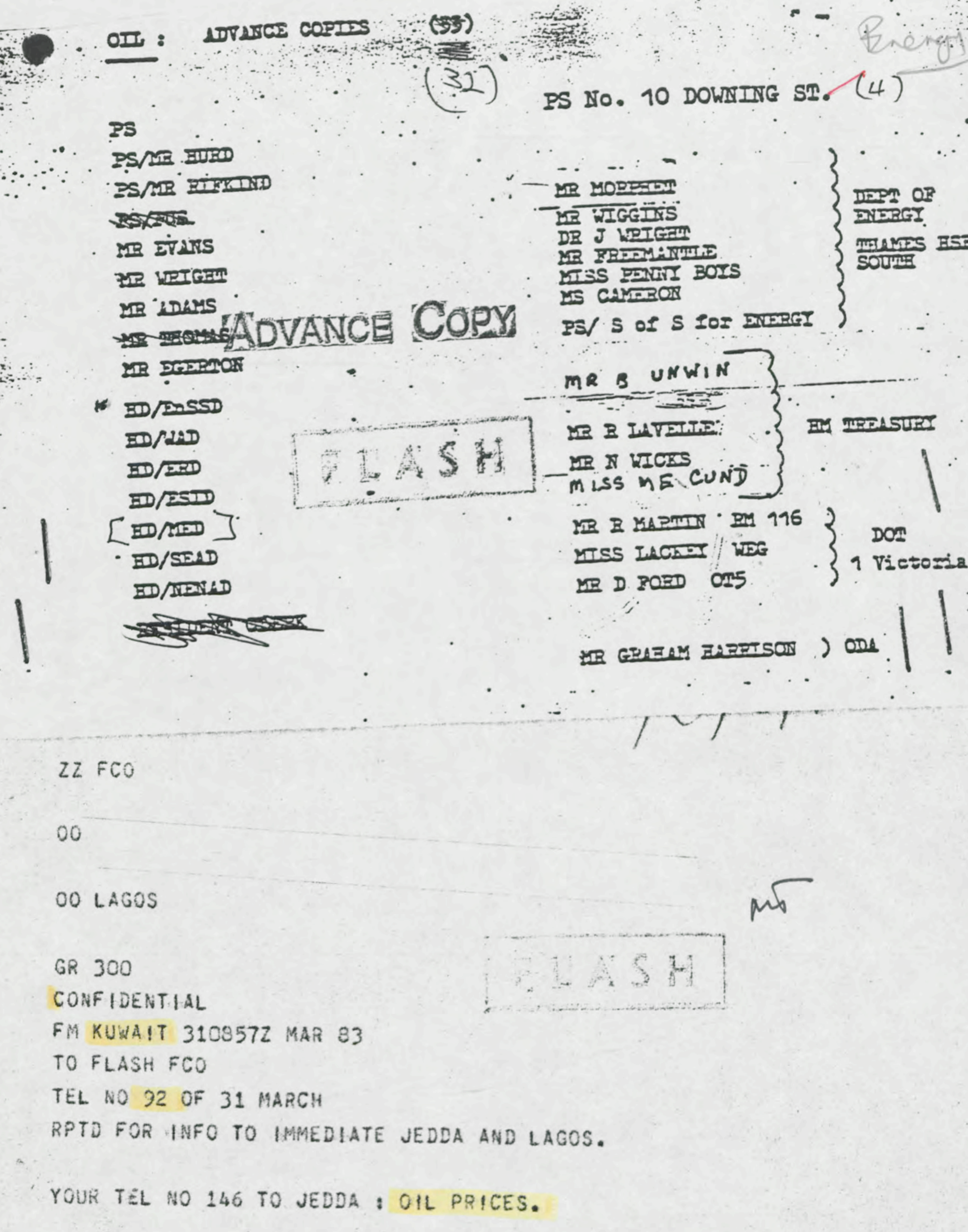

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MISS PENNY BOYS
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MISS LACKEY WEG
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MR GRAHAM HARRISON) ODA

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FM KUWAIT 310857Z MAR 83
TO FLASH FCO
TEL NO 92 OF 31 MARCH
RPTD FOR INFO TO IMMEDIATE JEDDA AND LAGOS.

FLASH

YOUR TEL NO 146 TO JEDDA : OIL PRICES.

I SPOKE ACCORDINGLY TO SHAIKH ALI KHALIFA AND LEFT SPEAKING NOTE. ALI KHALIFA WELCOMED THIS DECISION WARMLY, DESCRIBING IT AS A WISE AND BRAVE STEP FOR BNOC, BRITAIN AND OIL STABILITY GENERALLY. HE WOULD SAY AS MUCH PUBLICLY IN NEXT HOUR OR SO.

2. YESTERDAY HE AND SHAIKH YAMANI HAD SECURED AGREEMENT OF ALL OPEC COUNTRIES EXCEPT NIGERIA NOT TO ALTER THEIR PRICES, EVEN IF NIGERIAN PRICES WENT DOWN. THEY HAD THEN WORKED ON NIGERIA BUT HAD ONLY SO FAR PERSUADED THEM TO LIMIT ANY ''MATCHING'' REDUCTION TO A MAXIMUM OF 25 CENTS A BARREL. LAST NIGHT THEY HAD INCREASED PRESSURE ON NIGERIA TO DO NOTHING BUT NIGERIAN OIL MINISTER WOULD ONLY PROMISE TO DELAY A DECISION UNTIL PRESIDENT SHAGARI RETURNED TO LAGOS THIS EVENING. WITH THE INTERVENTION OF EASTER, THE NIGERIANS WERE UNLIKELY TO DECIDE UNTIL MONDAY OR TUESDAY. AS A TACTICAL PLOY, ALI KHALIFA AND YAMANI HAD NOT REVEALED TO THE NIGERIANS THE AGREEMENT OF THE OTHER 12 OPEC MEMBERS NOT TO REDUCE PRICES.

3. ALI KHALIFA SAID HE WAS NOW MORE HOPEFUL ABOUT THE SHORT TERM STABILITY THAN FOR SOME TIME. IF NIGERIA WOULD HOLD BACK, WELL AND GOOD, IF NOT, ONE COUNTRY'S DECISION TO LOP 25 CENTS OFF THE OPEC MARKER PRICE SHOULD BE CONTAINABLE.

4. AL KHALIFA HINTED THAT TODAY WAS THE CRUCIAL TIME TO MAKE POLITICAL REPRESENTATIONS IN LAGOS. I SAID I WAS SURE WE WERE DOING JUST THAT.

MELHUISH

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MR WRIGHT
MR ADAMS
MR THOMAS
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MS CAMERON
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MR R LAVELLE
MR N WICKS
MISS ME CUND
} HM TREASURY

MR R MARTIN RM 116
MISS LACKEY WEG
MR D FORD OT5
} DOT 1 Victoria St.

MR GRAHAM HARRISON) ODA

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FM TEHRAN 310930Z MAR
TO PRIORITY FCO
TELNO 182 OF 31 MARCH 83
INFO RIYADH, OSLO, KUWAIT, DOHA, ABU DHABI, DUBAI, MUSCAT, JAKARTA, CARACAS, BAGHDAD, TRIPOLI, ALGIERS, QUITO, MEXICO CITY, BAHRAIN, WASHINGTON, PARIS, UKDEL OECD, UKREP BRUSSELS, BRUSSELS, BNN, ROME, LUXEMBOURG, ATHENS, OTTAWA, CAIRO, DUBLIN, COPENHAGEN, THE HAGUE, TOKYO.

Mufwed to Chapness (1/4)

YOUR TELNO 146 : THE OIL SITUATION.

1. WE HAVE INFORMED THE NATIONAL IRANIAN OIL COMPANY (NIOC) OF THE NEW BNOC PRICES. HOOSHMAND, THE GENERAL MANAGER CRUDE SALES, THOUGHT THE PRICE REDUCTIONS WERE REASONABLE AND IN LINE WITH MARKET CONDITIONS .

2. NIOC HAS JUST ANNOUNCED ITS OWN OFFICIAL PRICES FOR CRUDE WHICH ARE DOLLARS 28 PER BARREL FOR LIGHT AND DOLLARS 26.9 FOR HEAVY. HOOSHMAND SAID THAT THE PRICE REFLECTED THE EXTRA COST TO CUSTOMERS DUE TO WAR RISK ETC, AT KHARG ISLAND WHICH HE ESTIMATED AT 40 TO 60 CENTS PER BARREL UNDER RRENT CONDITIONS. THE ADDITIONAL DISCOUNT HOOSHMAND SAID WAS TO COMPENSATE FOR THE QUOTE PSYCHOLOGICAL FACTOR UNQUOTE WHICH HINDERED IRANIAN OIL SALES. BY THIS HE MEANT THE RELUCTANCE OF PURCHASERS TO TAKE OIL FROM A WAR RISK AREA IN PREFERENCETO OTHER SUPPLIERS

THE ADDITIONAL DISCOUNT HOOSHMAND SAID WAS TO COMPENSATE FOR THE QUOTE PSYCHOLOGICAL FACTOR UNQUOTE WHICH HINDERED IRANIAN OIL SALES. BY THIS HE MEANT THE RELUCTANCE OF PURCHASERS TO TAKE OIL FROM A WAR RISK AREA IN PREFERENCECGO OTHER SUPPLIERS AND VARIOUS OTHER PHYSICAL DIFFICULTIES IN LOADING AT KHARG.

3. HOOSHMAND SAID THE IRANIAN GOVT. DID ACCEPT THE OPEC LIMITATION ON PRODUCTION AND WOULD PRODUCE BETWEEN 2.4 AND 2.5 MILLION BARRELS PER DAY (THIS IS A LITTLE OVER THE PUBLISHED FIGURE OF 2.4 MILLION BARRELS A DAY) AND WILL THUS EXPORT 1.9 TORXQMOT MILLION BARRELS A DAY. HOOSHMAND SAID IN CURRENT MARKET CONDITIONS EVEN THIS FIGURE MIGHT BE DIFFICULT TO ACHIEVE. HE DENIED DAMAGE TO THE OILFIELDS FOR EARLIER HIGH RATES OF PRODUCTION AND SAID CURRENT PRODUCTIVE CAPACITY WAS 3.2 - ASME MILLION BARRELS PER DAY. HOOSHMANDS VIEW WAS THAT CUSTOMERS GENERALLY WOULD HOLD BACK FROM SIGNING CONTRACTS DURING THE NEXT ONE TO TWO MONTHS UNTIL THE TREND OF SPOT PRICES BECAME CLEARER AND THAT THIS WOULD BE A DIFFICULT TIME FOR ALL PRODUCERS. IRAN WOULD NOT BREAK RANKS DURING THIS PERIOD.

4. HOOSHMAND SAID THE POLICY OF MAXIMISING OIL SALES IRRESPECTIVE OF PRICE WAS NOW MORE MUTED BECAUSE A SUBSTANTIAL INCREASE IN FOREIGN EXCHANGE RESERVES MEANT THAT IRAN COULD NOW WITHSTAND TWO MONTHS PRESSURE FROM CUSTOMERS TO REDUCE THEIR PRICES FURTHER. HOOSHMAND SAID THE IRANIAN GOVT. NOW BELIEVED THAT THEIR INTERESTS LAY WITH MAINTAINING THE CURRENT PRICE RATHER THAN PURSUING THEIR EARLIER POLICY. KICMHARACTERISTICALLY, HOOSHMAND HAS SOME GENEROUS WORDS ABOUT SAUDI ARABIA WHO HE SAID HAD IMPLICITLY OFFERED AT THE OPEC MEETING IN LONDON TO REDUCE THEIR PRODUCTION TO AS LOW AS 500,000 BARRELS PER DAY FOR A SHORT PERIOD IF THIS WAS NECESSARY TO DEFEND THE NEW MARKER PRICE.

5. HOOSHMAND SAID THAT EVEN WITH THE CURRENT REDUCTION IN PRICE AND VOLUMES THE IRANIAN GOVT. WOULD HAVE TO REVISE DOWNWARDS ITS 1983/84 BUDGET AND DEVELOPMENT PLANS.

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TO FLASH FCO
TELEGRAM NUMBER 258 OF 31 MAR 83
AND IMMEDIATE TO JEDDAH AND RIYADH
PRIORITY TO WASHINGTON, OSLO, KUWAIT, DOHA. ABU DHABI, MUSCAT
BIS TEHRAN, BAGHDAD, BAHRAIN, BEIRUT, JAKARTA, CARACAS, MEXICO CITY,
TRIPOLI, AND ALGIERS

MY TEL NO 249 (NOT TO ALL) : OIL PRICES

1. SUMMARY.
THE NIGERIAN GOVERNMENT HAS DECIDED TO LEAVE ITS CURRENT OIL PRICES UNCHANGED AND WILL BE ISSUING A PRESS STATEMENT TONIGHT TO THIS EFFECT. A FURTHER MESSAGE WILL BE SENT TO MR LAWSON NEXT WEEK.

2. COMMERCIAL COUNSELLOR CHECKED NIGERIAN POSITION AGAIN WITH DIKKO'S OFFICE LATE TODAY AND HAS NOW BEEN TOLD OF A PRESS STATEMENT TO BE ISSUED LATER TONIGHT AS BELOW. BELO-OSAGIE OF DIKKO'S STAFF ASKED FOR ADDITIONAL TWO POINTS TO BE MADE TO YOU

(1) NIGERIA WISHES TO ENSURE STABILITY IN THE OIL MARKET BY REACHING AN AMICABLE SETTLEMENT ON PRICES

(2) A DETAILED REPLY WILL BE SENT TO MR LAWSON'S MESSAGE NEXT WEEK SETTING OUT NIGERIA'S ''ACTUAL FEELINGS''.

3. PRESS STATEMENT WILL BE ON FOLLOWING LINES.:
BEGINS
THE FEDERAL GOVERNMENT OF NIGERIA HAS BEEN NOTIFIED OF RECENT PRICE CUTS APPROVED BY THE BRITISH GOVERNMENT WHICH LEAVE THE HIGHEST GRADES BROADLY IN LINE WITH OPEC THINKGIN. THE NIGERIAN GOVERNMENT REGARDS THIS AS A SETTLEMENT AND A GENUINE ATTEMPT TO RESTORE STABILITY INTO THE MARKET PLACE BY SEEKING A SOLUTION WHICH UNDERLINES THE BASIC INDIVISABILITY AND UNITY OF INTEREST OF OIL PRODUCERS, BOTH OPEC AND NON-OPEC. NIGERIA WILL THEREFORE LEAVE ITS OWN OIL PRICES UNCHANGED. THE FEDERAL GOVERNMENT EMPHASISES THE TASK FACING ALL IN MAINTAINING CONFIDENCE AND STABILITY BY STRENGTHENING THE EXISTING PRICE STRUCTURE AND RESTRAINING PRODUCTION. THE NIGERIAN GOVERNMENT WILL SPARE NO EFFORT.
ENDS

/4.

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4. DUGGAN THANKED BELO-OSAGIE FOR THIS ADVANCE NOTICE AND SAID THAT HE WAS SURE THAT THE NIGERIAN DECISION WOULD BE WELCOMED IN LONDON.

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FM ABU DHABI 311520Z MAR 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 79 OF 31 MAR 83

RPTD FOR INFO TO GULF POSTS, ALGIERS, TRIPOLI, BAGHDAD, BIS TEHRAN LAGOS, CARACAS, JAKARTA, MEXICO CITY, TOKYO, UKDEL OECD PARIS, AND WASHINGTON.

YOUR TELNO 146 TO JEDDA: THE OIL SITUATION

1. SUMMARY: THE INITIAL UAE REACTION TO BNOC'S PRICE PROPOSALS IS SATISFACTORY.

2. THE MINISTER OF PETROLEUM HAVING BEEN LAID UP WITH THE 'FLU FOR THE LAST FEW DAYS I WAS UNABLE TO SEE HIM UNTIL THIS AFTERNOON, WHEN I CALLED ON HIM AT HIS HOUSE IN MA' MOURA (NEAR THE ABU DHABI/DUBAI BORDER).

3. DR OTAIBA WAS COMPLIMENTARY ABOUT BNOC'S COURSE OF ACTION, SAYING HE UNDERSTOOD THEIR ''LEGAL AND CONCESSIONAL'' DIFFICULTIES. HE SAID HE HAD BEEN ON THE TELEPHONE TO THE NIGERIAN MINISTER OF OIL (ABOUT WHOM HE PASSED A DEROGATORY REMARK) TO TRY TO PERSUADE HIM NOT TO REDUCE HIS COUNTRY'S PRICES. THE MINISTER HAD GIVEN NO COMMITMENT: OTAIBA THOUGHT NIGERIA WOULD IN FACT COME DOWN 25 CENTS. HE SAID HE HAD THEN TELEPHONED ALGIERS AND TRIPOLI TO URGE THE NORTH AFRICAN PRODUCERS TO HOLD THEIR PRICES EVEN IF NIGERIA'S CAME DOWN.

4. OTAIBA SAID THAT HE STILL INTENDED TO HOLD THE NEXT MEETING OF THE MONITORING COMMITTEE ON 18 APRIL- IN LONDON. BEFORE THEN HE WOULD BE PASSING THROUGH LONDON ON HIS WAY TO VISIT TAOVMOVXI CIALS IN WASHINGTON AND TO ADDRESS THE FOREIGN AFFAIRS COUNCIL IN NEW YORK, AND HE WOULD RETURN TO LONDON ON APPROXIMATELY 15 APRIL. WHEN I ASKED HIM WHETHER THERE WAS ANYTHING HE WOULD PARTICULARLY LIKE ME TO CONVEY TO MR LAWSON HE ASKED THAT HIS REGARDS BE PASSED AND SAID HE HOPED TO SEE HIM ON HIS TRAVELS: HE DID NOT REQUEST ANYTHING MORE SUBSTANTIVE.

5. TODAY'S PRESS COVERAGE OF BNOC'S PRICE PROPOSALS, WHICH RELIED ON AGENCY REPORTS, WAS BROADLY SATISFACTORY.

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MR D FORD OT5
} DOT 1 Victoria St

MR GRAHAM HARRISON) ODA

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TO IMMEDIATE F C O
TELEGRAM NUMBER 128 OF 30 MARCH
INFO JEDDA, RIYADH, KUWAIT, DOHA, ABU DHABI, DUBAI, MUSCAT,
BIS TEHRAN, BAGHDAD, BAHRAIN, LAGOS, JAKARTA, TRIPOLI, ALGIERS
QUITO, MEXICO CITY, OSLO, WASHINGTON

YOUR TELNO 146 TO JEDDA: OIL SITUATION

1. I SPOKE TO OIL MINISTER CALDERON BERTI AS INSTRUCTED AT 1800 GMT ON 30 MARCH. HE SAID THAT HE THOUGHT THE BNOC PRICE PROPOSALS WERE VERY POSITIVE. EARLIER IN THE DAY HE HAD BEEN IN TOUCH WITH SEVERAL OF HIS OPEC COLLEAGUES BY TELEPHONE INCLUDING THE SAUDIS, KUWAIT AND ALGERIA. HE HAD NOT BEEN ABLE TO REACH THE NIGERIANS.

2. CALDERON SAID THAT, ON 29 MARCH, HIS INFORMATION WAS THAT NIGERIAWOULD MATCH BNOC PRICE CUTS CENT FOR CENT BUT, TODAY 30 MARCH, HE HAD HEARD THAT THEY WOULD NOT REDUCE MORE THAN TWENTY FIVE CENTS PER BARREL TO MATCH THE FORTIES CUT. HIS COLLEAGUES [illegible] THAT THEY SHOULD TRY TO PERSUADE NIGERIA TO AVOID ANY

2. CALDERON SAID THAT, ON 29 MARCH, HIS INFORMATION WAS THAT NIGERIAWOULD MATCH BNOC PRICE CUTS CENT FOR CENT BUT, TODAY 30 MARCH, HE HAD HEARD THAT THEY WOULD NOT REDUCE ORE THAN TWENTY FIVE CENTS PER BARREL TO MATCH THE FORTIES CUT. HIS COLLEAGUES WERE AGREED THAT THEY SHOULD TRY TO PERSUADE NIGERIA TO AVOID ANY FURTHER PRICE CUT, BUT WOULD ACCEPT TWENTY FIVE CENTS WITHIN THE CURRENT OPEC PACKAGE.

3. ALGERIA HAS TOLD CALDERON THAT THEY WILL HOLD THEIR PRICES. CALDERON HAS BEEN DELEGATED TO SPEAK TO THE MEXICANS IN A SIMILAR VEIN BUT HAS NOT YET DONE SO. HE SAID THAT HE EXPECTED MOST IF NOT ALL HIS OPEC COLLEAGUES TO ISSUE A STATEMENT SOON REAFFIRMING THEIR COMMITTMENT TO DEFEND THE TWENTY-NINE DOLLAR MARKER.

4. COMMENT. CALDERON SEEMED GENUINELY RELIEVED AT THE LIMITED SCALE OF THE BNOC PROPOSALS. I THINK HE ALREADY KNEW WHAT THEY WERE, PRESUMABLY FROM HIS OPEC TELEPHONE CONTACTS BEFORE I SAW HIM.

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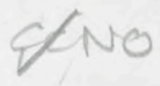

Foreign and Commonwealth Office

London SW1A 2AH

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Prime Minister

MES 29/3

29 March 1983

Dear Julian,

in Box

Mr Pym has seen a copy of your letter of 28 March to Michael Scholar about BNOC's price proposals for February, March and April. Mr Pym accepts that what is proposed is a reasonable response to the demands of the market and the conflicting pressures from OPEC. BNOC have done well to hold off so long; and we would expect Yamani to recognise this even though he talked of holding off until April. It is less easy to predict other OPEC and, in particular, Nigerian reaction but we shall of course send detailed advance guidance to posts enabling them to present the move as cautious and reasonable.

As you know, Mr Pym plans to visit Saudi Arabia and the UAE from 8 - 12 April. Oil is bound to be among the subjects discussed but the primary purpose of the visit is to set the seal on restored Anglo/Saudi relations following the successful Arab League visit to London. Mr Pym therefore hopes that by moving now, BNOC will have done enough to avoid a further move in the near future. If BNOC were to move again before Mr Pym's visit, this would be bound to overshadow the broader aspects of the visit and could possibly set back relations once again.

I am copying this letter to John Kerr (Treasury) and Michael Scholar (No 10).

Yours ever

John Holmes

(J E Holmes)
Private Secretary

J D West Esq
Private Secretary
Department of Energy
Thames House South
Millbank SW1

bc: PS/Mr Rifkind
PS/PUS
Sir J Bullard
Mr Evans
Mr Adams
Mr Egerton
ESSD
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1 Mr Bitter
2 Mr Cole A.J.C 30/3.
To see
MJS 30/3

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Prime Minister 2

MJS 28/3

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01-211-6402

M C Scholar Esq
10 Downing Street
London SW1

28 March 1983

Dear Michael,

My Secretary of State met Lord Croham and Ian Goskirk of BNOC this evening to discuss North Sea oil prices for February and March, both of which remain unresolved, and their thinking for April. It was agreed that for February enough customers had accepted BNOC's proposed price of $30.50 a barrel for them to insist on it. For March they believe that they can settle on the basis of $30 a barrel for the Brent blend (the most widely traded North Sea crude); this would enable them, consistently with the pattern of market value, to increase the gap between Brent+other crudes (including Forties) by 25 cents a barrel. It would mean that the main North Sea crude, which would effectively set the North Sea "marker" price, did not undercut the main Nigerian crude.

For April BNOC will propose that the March price should continue to apply provisionally, but they will at the same time suggest a further review of prices in the light of developing market circumstances.

BNOC will send telexes to its customers and suppliers on these lines on Wednesday afternoon, 30 March. Mr Lawson intends to telephone Sheikh Yamani tomorrow evening to give him advance warning. Since this course of action meets pretty well all Yamani's representations, Mr Lawson will seek his help in presenting these proposals as a helpful step towards stabilising the market.

The Chancellor concurs with this course of action.

Mr Lawson believes that this move by BNOC should have a helpful impact. It is not possible to remove all uncertainty about the North Sea price for April and later, but the proposed announcement gives a signal in the right direction. It also gives more time for events in the markets to help us. And it would be very difficult for Nigeria or any other OPEC members to use it as a pretext for a price war.

I am sending copies of this letter to John Kerr and Brian Fall.

Yours ever,

JULIAN WEST
Private Secretary

1 [illegible] 1983

FILE RM

10 DOWNING STREET

From the Private Secretary 28 March, 1983

THE OIL PRICE AND THE UNITED KINGDOM ECONOMY

Thank you for your letter of 25 March. As you will be aware, a slightly modified version of the proposed message from the Prime Minister to the Rulers of the UAE, Kuwait and Qatar was approved and issued over the weekend. The texts will be available to you from the relevant FCO telegrams.

I am copying this letter to John Kerr (HM Treasury) and Roger Bone (Foreign and Commonwealth Office).

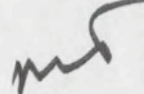
A.J. COLES

J.D.West, Esq.,
Department of Energy

CONFIDENTIAL

GR 350
CONFIDENTIAL
FM KUWAIT 270500Z MAR 83
TO IMMEDIATE FCO
TEL NO 82 OF 27 MARCH
RPTD FOR INFO TO PRIORITY LAGOS, WASHINGTON AND JEDDA.

PS/PRIME MINISTER
NO.10. DOWNING STREET.



OIL.

1. MR HURD SAW THE KUWAITI OIL MINISTER THIS MORNING. ALI KHALIFA SPOKE OF THE IMPORTANCE OF THE UK FOR THE STABILITY OF THE PRESENT OPEC PRICING AGREEMENT. MR HURD REPLIED ALONG STANDARD LINES. ALI KHALIFA WENT ON TO DESCRIBE NIGERIA AS THE WEAKEST LINK IN THE OPEC CHAIN. HE URGED THAT OUR DISCUSSIONS WITH THT NIGERIANS SHOULD BE AT THE POLITCICAL RATHER THAN TECHNICAL LEVEL. HE WAS IN CONSTANT TOUCH WITH THEM. THE NIGERIANS WERE NOW SERIOUSLY FRIGHTENED AT THEIR CURRENT AND PROSPECTIVE LOSS OF EARNINGS. ALI KHALIFA SAID THAT HE UNDERSTOOD THE TECHNICAL CASE FOR LOWERING BNOC PRICES. BUT WHEREAS BRITAIN WAS A RELIABLE PARTICIPANT IN THESE AFFAIRS THE NIGERIANS WERE NOT. THIS MADE A DIFFERENCE TO THE EQUATION. IF HE WERE AN IMPORTER HE WOULD RATHER PAY MORE FOR UK CS OIL AND OBTAIN IT AT THE TIME CONTRACTED FOR, THAN PAY SLIGHTLY LESS FOR NIGERIAN OIL BUT DEAL WITH A HOPELESSLY INEFFICIENT NIGERIAN BUREAUCRACY. AS AN EXAMPLE HE SAID THAT THE NIGERIAN OIL COMPANY'S TELEX HAD NOW NOT WORKED FOR TWO WEEKS. THE NIGERIANS' IDEAS WERE CONFUSED AND CONTRADICTORY. THEY HAD TOLD KUWAIT THAT IF THE UK DROPPED ITS PRICE BY 50 CENTS THEY WOULD DO NOTHING: BUT IF UK OIL DROPPED BY 75 CENTS THE NIGERIANS WOULD LOWER THEIR PRICES BY THE SAME AMOUNT. ALI KHALIFA SAID THAT THE OPEC AGREEMENT WAS NOT AT RISK FROM OTHER OPEC PRODUCERS: EVEN THE LIBYANS AND THE IRANIANS WERE PLAYING THEIR PART.

2. ALI KHALIFA ACKNOWLEDGED THAT THE SOVIET UNION WAS THE MAJOR FORCE UNDERMINING OPEC. BUT THERE WAS NOTHING THAT COULD BE DONE ABOUT THIS. MR HURD ASKED WHETHER THE US WAS NOT ALSO CAUSING PROBLEMS BY SELLING ITS OWN OIL INTERNALLY WELL BELOW THE OPEC PRICE. ALI KHALIFA SAID THAT IN HIS VIEW THIS DID NOT AFFECT THE INTERNATIONAL MARKET: THE AMERICANS WOULD PRODUCE THE SAME QUANTITIES DOMESTICALLY WHATEVER THE STATE OF THE WORLD MARKET, AND THIS HAD NO EFFECT ON THE PRICE THEY WERE PREPARED TO PAY FOR IMPORTED OIL.

MELHUISH

STANDARD
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MCAD

WAD
SEAD
WED
MR THOMAS
MR HAYES
MR EGERTON

ADDITIONAL DISTRIBUTION

OIL

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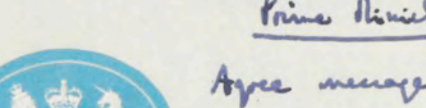


Prime Minister

Agree messages subject to the views of Mr. Pym who is being consulted over the weekend?

A.J.C. 25/3.

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01-211-6402

Robin Butler Esq
Principal Private Secretary
10 Downing Street
London SW1

25 March 1983

Agreed as you have amended MT

Dear Robin,

THE OIL PRICE AND THE UNITED KINGDOM ECONOMY

As requested in your letter of 24 March I attach the draft messages to the three Gulf Rulers.

I am copying this letter to John Kerr and Roger Bone.

Yours ever,

J D WEST
Private Secretary

DRAFT MESSAGE FROM THE PRIME MINISTER TO RULERS OF UAE, KUWAIT AND QATAR

1. At this time when so many problems~~, economic as well as political,~~ preoccupy our two countries, I am writing to Your Highness about developments in the oil market which we have been following with close attention. ~~The British Government have been following these with close attention, as I am sure you have. We were grateful to be kept informed recently during the long OPEC meeting in London.~~

2. ~~I thought that it would be helpful if I set out my Government's views on recent developments in the world oil market. We~~ The British government would like to see greater stability in the oil market. The reduction we have seen recently in international oil prices will give support to the world economy at a time of world recession. This in turn should show itself in due course in increased demand for oil. But we share your interest in avoiding a further sharp fall in prices. We also consider that severe fluctuations in prices would be contrary to the interests of producers and consumers alike.

3. We have done what we can to assist stability of the oil market. After the Geneva OPEC meeting the British National Oil Corporation (BNOC) delayed any immediate decision on its prices despite strong pressure for a reduction. When it did propose a reduction this was the minimum judged necessary in the interests of settling the market for its oil. It was a level which would have been consistent with the re-establishment of the Arabian Light marker price of $30 per barrel. Again, following the OPEC

meeting in London, which reached agreement on a new marker price of $29, BNOC refrained from making any immediate move on prices.

4. It is likely, however, that in due course BNOC will need to make an adjustment though it will do so only to the extent that the market situation makes this essential. The British National Oil Corporation has under the law only a limited role as a trader in oil; it has to negotiate a price for its oil which is acceptable to both its suppliers and its customers. It cannot store production beyond a very few days and cannot refuse to take the oil placed with it except at many months notice. Its price can therefore only reflect market forces. Neither BNOC nor the British Government can control prices or production any more than the US Government control these matters in the United States. Nevertheless we recognise the very great efforts made by the OPEC member countries to reach an agreement aimed at steadying the market and BNOC will also act to the greatest extent possible in the interests of stability in the market.

5. I have seen suggestions that any price reduction by BNOC would be seen as leading to a price war. Since BNOC can do no other than follow existing market conditions such suggestions are wrong and unhelpful. They provoke in themselves instability in the oil market. Oil from several other sources of equal or greater value than North Sea oil is already priced below it. If BNOC is obliged to make a reduction it will be limited to what that situation imposes.

6. I am glad that Mr Lawson, the British Energy Secretary, was able to have contact recently in London with Dr Mana al Otaiba (for Kuwait Shaikh Ali Khalifa) (For Qatar: colleagues from OPEC countries) and I hope that it will be possible for our two countries to keep in close touch in future. I hope that we shall also continue to keep in touch, at both Ministerial and diplomatic level, on the many other important economic and political questions that currently affect our interests, in particular, for instance, questions that affect the security of the Middle East region such as the issue of Palestine and the conflict between Iran and Iraq.

Energy Jan 80

North Sea Oil prices

25 MAR 1983

CONFIDENTIAL

10 DOWNING STREET

From the Principal Private Secretary

24 March 1983

Dear Julian,

THE OIL PRICE AND THE UNITED KINGDOM ECONOMY

The Prime Minister held a meeting with your Secretary of State and others this evening to discuss his minute of 16 March and the note attached to it. The meeting also had before it the Foreign and Commonwealth Secretary's minute of 18 March and Mr. Sparrow's minute of 23 March. The others present were the Chancellor of the Exchequer and Mr. Middleton; the Secretary of State for Industry and Mr. Gill; the Secretary of State for Trade and Mr. Roberts; the Minister of State, Foreign and Commonwealth Office (Mr. Hurd) and Mr. Evans; Sir Robert Armstrong, Sir Kenneth Couzens, Mr. Sparrow and Mr. Walters.

Your Secretary of State said that what had so far happened to the oil price was satisfactory; but a sharp further fall would be disruptive, especially since the price was likely to increase again later. However, the United Kingdom's ability to influence developments was limited. Ideas about consumer/producer dialogues were unlikely to achieve any practical purpose and, while there might be some price at which it would be worth considering whether steps should be taken to limit production of North Sea oil, such a move would be damaging at present. In the short term, the United Kingdom had to consider what line it could most usefully take in discussions with the oil companies and other producers, and try to get other governments to share our approach: in this connection, the approach to the Economic Summit at Williamsburg would be important.

In discussion, there was general agreement with the conclusions of your Secretary of State's paper. In particular, the following points were made:-

(i) It was agreed that the United Kingdom's objective for the time being should be to maintain the nominal prices which had emerged from the recent OPEC meeting, which would mean a slowly declining real price over the next two to three years.

/ (ii)

(ii) Although there would be theoretical advantages in limiting production of North Sea oil while prices were depressed, the scope for doing so was limited to royalty oil, and Government intervention in the levels of oil production might discourage companies from undertaking exploration and future development. There would also be substantial effects on Exchequer revenue. At present, therefore, no steps should be taken to limit North Sea output.

(iii) Nothing was to be gained by pursuing ideas of promoting a consumer/producer dialogue.

(iv) It would not be in the United Kingdom's overall interest to attempt to establish a more formal link with OPEC; but the good relations with the main OPEC producers, which had been informally established, should be maintained. The Foreign and Commonwealth Office were proposing that the Prime Minister should send messages, on the lines of the message previously sent to King Fahd, to the Rulers of the three Gulf States with which she had particularly close links. It was also agreed that the Saudi Arabians should be told privately in advance of any proposal by BNOC to change its term oil price, and that the Nigerians should be told simultaneously with the announcement.

(v) If there was a sharp fall in oil prices, the Chancellor of the Exchequer might have to consider fiscal action to restore the situation, as envisaged in his Budget speech. Such action might include the taxes on oil. But there was no strong argument for increases in these taxes on energy policy grounds in order to discourage oil consumption while the oil price was low.

(vi) While an EEC levy on imported oil could, in certain circumstances, result in a transfer of resources from other EEC countries to the United Kingdom, it was unlikely that such a proposal would be acceptable to other EEC countries and such a levy would have the disadvantage of increasing costs of certain sections of UK industry: the Prime Minister said that for this reason she was opposed to a levy.

(vii) The British Government could best pursue its objectives by persuading BNOC and the oil companies that any further fall in the BNOC term price should be as small as possible, while maintaining a low profile in relation to OPEC. It would be helpful in this respect if any further fall in the BNOC term price could be accompanied by a positive

/ statement

statement from influential people such as Sheikh Yamani, and if members of the American Administration could be persuaded not to encourage expectations of further reductions in the oil price. So far as possible, we should try to underpin the present level of prices by stressing publicly the prospects of higher demand for oil later in the year.

BF On the next steps, the Prime Minister asked the Minister of State, Foreign and Commonwealth Office, to clear with your Secretary of State the draft messages to the three Gulf Rulers; and asked your Secretary of State to keep in touch with the Chancellor of the Exchequer over discussions with BNOC about any concessions to customers which they were thinking of introducing with the aim of minimising further reductions in the term price. Efforts should be made to persuade Sheikh Yamani and other influential people in the oil industry to make helpful statements when BNOC announced proposals on its term price. She would arrange for Ministers to meet again if developments in the oil market looked like making it necessary to review the conclusions reached at this meeting.

I am copying this letter to the offices of those who were present at the meeting.

Yours ever,

Robin Butler

Julian West, Esq.,
Department of Energy.

10 DOWNING STREET

Robin.-

John Sparrow has minuted on Oil Prices.
I have included it in the meeting folder

Content.?

Andy.
23/3

Yes

FERB

10 DOWNING STREET

Oil Prices Meeting

RTA will be accompanied by Mr Colvin at the above tomorrow.

OK ?

I have told him 'no'.

Mal

23/3

10 DOWNING STREET

~~Robin~~

Mtg of Ministers Oil

Do you wish Cab Office to do minutes?

[signature]
23/3

No thank you.
I'll do them

FERB
23.3.

Qa 06300

To: PRIME MINISTER

From: JOHN SPARROW

23 March 1983

The Oil Price and the UK Economy

1. You are discussing tomorrow Nigel Lawson's minute of 16 March to you and the paper prepared by his Department.

2. I agree with him that nothing that has happened so far to oil prices justifies a departure from the Government's present policies towards North Sea oil depletion and OPEC. The real oil price is still substantially above the pre-1979 price increase level and therefore could fall. I suggest that Ministers need to look more closely at the implications of oil prices falling 'too fast' or 'too far'. If we accept that we have no influence on the pace or extent of oil price changes then it is all the more important that we have properly prepared positions for dealing with the consequences of external events beyond our control.

3. The first question is to settle whether the UK economy as a whole gains from lower oil prices. As our net oil exports are small relative to GDP and we export a third of our GDP the presumption must be that on balance we do benefit from the improved world economic outlook (three-quarters of our exports go to OECD markets). If the exchange rate follows oil prices down, UK competitiveness will improve.

4. There are two major questions requiring contingency planning if oil prices should fall sharply:

(a) What happens if the foreign exchange market over-reacts? If sterling were unduly marked down the benefits of lower oil prices could be more than offset by higher import prices with consequent damage to the Government's anti-inflation policy objectives.

(b) What happens if substantially lower oil prices lead to a sharp fall in UK oil revenues and hence a higher PSBR? Compensatory taxation on oil could help and have other advantages. There may be reasons for substituting taxation for declining oil prices - preferably on a multinational basis for reasons of competitiveness - e.g. smoothing out oil price movements, maintaining progress on energy conservation, encouraging development of non-OPEC energy sources, and EC budgetary advantages to the UK if it took the form of an oil import levy. In any event a higher PSBR could be tolerated - especially given the Government's record for fiscal responsibility - as long as the inflation risk is contained and the higher PSBR can be financed within existing monetary targets at acceptable interest rates.

5. In case oil prices fall sharply, there are three further questions which we ought to have in mind:

(a) Could Ministers envisage any future situation justifying reversing the 'hands off' current depletion policy? It might well be that with oil prices low it would be sense to prolong the period of UK self-sufficiency.

(b) What are the implications for the international banking system of any further or sharp fall in oil prices? UK banks may not be heavily exposed in the vulnerable oil producing markets like Mexico and Venezuela but they could be caught up in the consequences of further deterioration in those markets.

(c) Are Ministers satisfied that there is no set of circumstances (e.g. Middle East instability arising from OPEC collapse) in which worthwhile Western political objectives could be attained by co-operating with oil producers in the Middle East to maintain a floor price level?

6. I am sending copies of this minute to the recipients of Nigel Lawson's minute.

B.

Ref: B06748

PRIME MINISTER

c Sir Robert Armstrong

The Oil Price and the United Kingdom Economy

BACKGROUND

You are chairing an ad hoc Ministerial meeting at 6.00 pm on 24th March to discuss the Secretary of State for Energy's minute of 16th March covering a note by the Department of Energy. The Foreign and Commonwealth Secretary commented in his minute to you of 18th March.

Flag A
Flag B

2. The origins of the Department of Energy's paper lie in the representations made to the Foreign and Commonwealth Secretary by the Mexican President and Foreign Minister during the Royal visit to Mexico in February in favour of a dialogue between OPEC and non-OPEC oil producers. But since then, attention has focussed on the general climate of uncertainty following the precarious agreement reached with so much difficulty by OPEC ten days ago and its implications for British policy.

3. The note covers four issues in some detail.

a. Implications of a falling oil price for the United Kingdom economy. The note concludes that the balance of advantage for the United Kingdom, over a two to three year period, lies in a moderate and gradual fall in the oil price; but that a steep and fast fall would be damaging. This conclusion relies on a number of predictive judgements and quantitative assertions that could be subject to significant margins of error. This is probably unavoidable. There are however points of detail which may be open to dispute. For example, the Department of Trade contests the assertion in paragraph 3(ii) that "our exports are heavily weighted towards energy producing and self-sufficient countries", arguing that 81 per cent of British exports go to oil importing countries and only 16 per cent to oil exporting countries.

b. United Kingdom influence on output and prices. The note states that United Kingdom oil output is not on a scale which can have a significant effect on world supply and demand. The level of output is in practice controlled by the licensees, not the Government.

Fresh powers would be required if the Government wished to reduce production. The Government have taken the view that the market system should determine output and price.

c. United Kingdom relations with OPEC. The note concludes that there would be major objections to an agreement with OPEC, formal or informal. It is cool to the idea of a consumer/producer dialogue, which could in any case be unnegotiable in the face of United States and German opposition.

d. Implications for the United Kingdom line in forthcoming international discussions. The note sees no case for United Kingdom support for increased oil taxes to maintain the right long term signals to consumers about the oil price. In the European Community, the note sees some advantage in an oil import levy but not in a Minimum Support Price. It concludes that the line at international meetings (European Council, Williamsburg etc) which would be helpful to the United Kingdom would be that the fall in oil prices that has already occurred was favourable to world growth but that further sharp falls would create problems and impose adjustment difficulties.

4. As far as it goes, the general thrust of the note is unlikely to be contested. There are points of detail (eg in paragraph 3(ii), as noted above) which might justify further work by officials; and there are additional facts which are relevant and which might have been included (for example, that it is the significant quantities of Soviet oil which are being released on to the European market at well below the OPEC price which constitute one of the pressures on BNOC to cut the UKCS oil price). However none of these points is likely to alter the main conclusions of the paper. It would therefore seem profitable for the meeting to concentrate on those issues on which decisions will need to be taken in the period immediately ahead.

HANDLING

5. You will wish to invite the Secretary of State for Energy to introduce his note. The Chancellor of the Exchequer, Foreign and Commonwealth Secretary and Secretary of State for Trade will all wish to comment.

6. You may wish to focus discussion on the following points.

a. Are all agreed that the balance of United Kingdom interest lies in lower oil prices, provided that they do not fall too far and too fast? Can this be more accurately defined? Does it mean that our immediate interest is in trying to ensure that the OPEC agreement holds for the time being?

b. If so, what are the implications for UKCS oil price and production? What powers do we have to influence the price? And the rate of depletion? Should these powers (notably the participation agreements) be re-examined? If it is agreed that we neither can nor should intervene to prevent BNOC dropping the UKCS oil price by more than 50 cents a barrel, what diplomatic action should we take to explain our stance to OPEC? (The Foreign and Commonwealth Secretary should be asked to speak to the suggestions in his minute of 18th March.)

c. What should be the United Kingdom line on oil prices at forthcoming international meetings, notably the Williamsburg Summit? Should further work be commissioned by officials on the consumer/producer dialogue, oil import levy etc?

CONCLUSIONS

7. Subject to the course of the discussion, you may be able to sum up as follows:

a. note broad agreement on the analysis in the note by the Department of Energy, namely that while there is economic advantage to the United Kingdom in lower oil prices, prices should decline gradually, not precipitately;

b. agree that while the United Kingdom has no powers to determine the path of prices, it is important presentationally to be able to continue to say that we are not leading prices down;

c. agree that there would be major objections to the United Kingdom associating itself with the OPEC agreement, whether formally or informally; but invite the Foreign and Commonwealth Secretary, in consultation with the Secretary of State for Energy and the Chancellor of the Exchequer, to advise on the diplomatic action that we should take to explain our stance to key members of OPEC;

d. officials should be instructed to monitor the developing situation in preparation for the Williamsburg Summit; and to examine the structure of BNOC and the terms of the participation agreement to see if there is scope for reducing the Government's profile in relation to BNOC decisions.

David Goodall

23rd March 1983

A D S GOODALL

10 DOWNING STREET

Michael

Oil Prices 1800 24/3

A.D.S. Goodall will accompany

RTA.

Do you wish them to supply a brief?

brief requested
~~Lorie~~

Yes please

M

Roger

21/3

CONFIDENTIAL

DEPARTMENT OF ENERGY
THAMES HOUSE SOUTH
MILLBANK
LONDON SW1P 4QJ

01-211 4391

SIR KENNETH COUZENS KCB
PERMANENT UNDER-SECRETARY OF STATE

19 March 1983

Dear Brian

THE US AND OIL PRICES.

I think Julian Bullard may have explained to you our concern about the line which members of the US Administration are taking on the recent OPEC agreement and on the oil price generally. Sir Peter Baxendell of Shell has expressed to us his concern about this, and I attach a copy of a note about evidence given to a Congressional Committee on 17 March by US Secretary for Energy Hodel. Kit McMahon of the Bank of England tells me that the US Treasury are taking a similar line at international meetings and that something comparable may have been said by Secretary Schulz.

Our Secretary of State has arranged to speak to Secretary Hodel on the telephone tomorrow to urge a more cautious line. It does seem to us that if it were possible to convince Secretary Schulz of the need for caution, that would be a great gain. We therefore wondered whether the Foreign Secretary might be willing either to speak to Mr Schulz or to send him a message. I attach a note of a possible line, though you will of course be better able than we to get any political aspects right. Another possibility which occurs to us is that Sir Oliver Wright might talk to the President of Exon and ask whether he was confident that the US Government line was fully appropriate; but clearly that would be a more speculative and indirect route.

I am copying this to John Kerr at the Treasury, and John Coles at No.10.

Yours
Ken Couzens

B J P Fall Esq
Private Secretary to the
Secretary of State for Foreign
and Commonwealth Affairs
Downing Street, SW1.

CONFIDENTIAL

THE SECRETARY OF STATE MIGHT SAY:-

We are rather worried about reports reaching us of comments by the US Administration on the recent OPEC agreement and on the oil price. Of course we agree that the fall which has taken place is helpful to the world economy. But we do not think it would be helpful to take responsibility for destroying the recent OPEC agreement by telling the markets that it might fail; or to produce a sharp and precipitous fall in the price. Gradual changes are one thing. Further shocks to the world economy, in either direction, are another. They are destabilizing and can produce political as well as economic trouble.

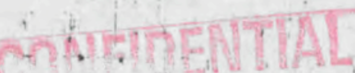
The US authorities know well the risks to the international (and US) banking system if Mexico were to be plunged into renewed difficulties, with political risks also. There would be acute problems for countries like Venezuela, Nigeria and Indonesia. The balance of strength in the Middle East could be affected. Many of the problems of a sharp adjustment would hit the system before the more pervasive benefits come through: that is why gradualism is better. There would also be exchange rate upheavals and a problem of redirecting exports from industrial countries. Moreover, if the fall went too far (eg to $20) we believe that we would before long be faced with a price rebound. Meanwhile there would have been the wrong signals for investment, substitution and conservation.

We in London know how much effort and political capital the OPEC countries put into the recent agreement. We have no special sympathy for the OPEC cartel and believe strongly in market principles. Nevertheless, we fear there will be considerable bitterness among the countries if major OECD countries appear to be

destroying the agreement.

We hope therefore that the State Department might use its influence to prevent official "talking down" of the agreement, and the oil price, by the Administration; especially in the present febrile market.

629/3/83.



PS/Secretary of State

cc PS/Minister of State
PS/PUSS (Commons)
PS/PUSS (Lords)
PS/PUS
Mr Guinness
Mr Morphet
Mr Wiggins
Mr Brown
Mr Meyrick

WORLD OIL PRICES: US REACTIONS

You asked for information on recent press reports of the US Secretary Hodel's remarks on oil prices. The Embassy have a full report on its way to us in the bag. The gist of what was said is as follows.

2 Hodel appeared yesterday before a Congressional Sub-Committee on government operations. He said that he did not believe that the new $29 pb marker price would hold. He expected/to drop to $25 (the day before, he said that he expected prices to drop to the mid $20s). In response to a further question, he said that even if prices should drop below $20, he still believed that substantial incentives for oil exploration and development would remain.

/prices

3 The Embassy note that these remarks follow a consistent line/taken by US officials. Georde Badley (Assistant Under-Secretary at the Department of Energy) said in public recently that "even a relatively precipitous decline in oil prices to $20 would be manageable from an energy perspective The adverse effects on oil company profits and on energy security from diminished incentives for exploration, conservation and alternative energy developments would be more than offset by increased efficiency in other sectors, higher economic growth and employment, and lower inflation. A decline in oil prices is generally a good thing".

/previously

4 I will forward the Embassy's full report as soon as it arrives. Meanwhile, we shall prepare briefing for the Embassy on the lines of the paper that the Secretary of State has sent to the Prime Minister.

Penelope Boys

P A BOYS
ICU
Room 1411
Ext 5509
18 March 1983

CONFIDENTIAL

Weekend box

PRIME MINISTER

THE OIL PRICE AND THE UNITED KINGDOM ECONOMY

Mr Lawson has circulated the paper he has been preparing on this subject. A meeting has been arranged for Thursday to discuss it. Since the paper is long, I thought that you might like to see a copy over the weekend.

I have asked Alan Walters to brief you on it. — at Flag C

The propositions in the paper boil down to:-

i) the United Kingdom's objective should be to maintain the present nominal price, which would mean a slowly declining real price over the next two to three years;

ii) there is no future in

- limiting North Sea output;
- closer association with OPEC;
- launching a consumer/producer dialogue;

as a means of trying to influence the oil price;

iii) there is also no future in

- raising the domestic tax on oil consumption to make sure that people do not over-invest in oil-burning capacity during the temporary period while the price is low;
- trying to keep up the BNOC price by proposing an EEC levy on imported oil;

iv) our strategy should be to try to keep up the BNOC price, maintaining a low profile; and underpin the price by talking up the prospects of revived demand later in the year.

A comment by the Foreign and Commonwealth Secretary is attached at flag B

18 March 1983

F.E.R.B.

CONFIDENTIAL

B

PM/83/24

PRIME MINISTER

The Oil Price and the UK Economy

1. I should like to make one or two comments on Nigel Lawson's minute of 16 March to you and on the Department of Energy paper on this subject.

2. I do not quarrel with the conclusions drawn by Nigel Lawson and with the general thrust of the paper. But I should like to take further the important question of relations with the more important OPEC countries.

3. The political importance of good relations with the Saudis and the other Gulf States within the Middle East, or with Nigeria in the African context is obvious. In terms of our commercial interests, our visible exports to Saudi Arabia and Nigeria last year were worth more than a billion pounds each.

4. It is, in my view, essential that the leaders of these countries are given no excuse for making us a scapegoat if BNOC are obliged, in the near future, to lower their price offer, particularly if this goes below $30 a barrel. Nigel Lawson's readiness over the past few weeks to receive Oil Ministers from these countries has made a substantial contribution towards ensuring that they are fully aware of the constraints on ourselves and BNOC and to preempt accusations that the United Kingdom is instigating a price war. Your own message to King Fahd was, I am sure, a vital part of the same operation. In the days ahead, I believe that we should make further use of such messages: I am thinking for example of possible messages from yourself to three of the other Gulf Rulers you know personally (UAE, Kuwait and Qatar), who are likely to

/set the

set the tone for their governments' reaction to any move by us. I also think that at the appropriate moment messages from Nigel Lawson to some of his colleagues, eg Yamani of Saudi Arabia, will be necessary. And, depending on the report we get from Cranley Onslow and Gerard Vaughan (who are at present visiting Lagos), a message from you to President Shagari could also be very useful. It is important to get across at the highest level the simple message that, while we are doing everything possible to avoid market de-stabilisation, and want the highest possible price for our oil, BNOC prices need, in the last resort, to reflect market forces.

5. On the question of a producer/consumer dialogue, I would note that, although it is unlikely to gain support from the Americans and the FRG, others (eg the French) may seek to promote discussion of it in various international fora. If it does come up, I think we should listen to others' views: while we should not ourselves promote a producer/consumer dialogue, it would not seem in our interests to be in the lead against the idea.

6. In the longer run, I wonder whether it might not be useful for officials to look carefully at the structure of BNOC and the participation agreement to see if there is any way of making their role less conspicuous in a weak market situation without of course undermining fundamental security of supply safeguards. It is striking that the Americans, who produce far more oil than ourselves, have been immune from the sort of misrepresentation and pressure which we have suffered in recent weeks.

/7. I am

7. I am copying this minute to the Chancellor of the Exchequer, the Secretaries of State for Energy, Industry and Trade, Sir Robert Armstrong and Mr Sparrow.

(FRANCIS PYM)

Foreign and Commonwealth Office
18 March 1983

18 MAR 1983

CONFIDENTIAL

cc Mr. Scholar
Sir Anthony Parsons
Mr. Mount

MR. BUTLER

THE OIL PRICE AND THE UNITED KINGDOM ECONOMY

Department of Energy Memorandum of 16 March.

The main lesson is that we cannot influence the world producer price of oil. We are quite powerless, even to "talk up" the price of oil later in the year. We should save our talk for more mundane political purposes.

What we need to know is not how we would like the oil price to develop (a slow fall is Energy's and Treasury's answer) but how it is likely to develop. There is some vague suggestion that the oil price may fall through the summer of this year, but that it should rise during the autumn. But the paper seems unsure, and the Secretary of State is clearly unwilling to impose his judgement on the oil companies' production programme. I am sure the Secretary of State is right in allowing the oil companies to determine the rate of depletion. It is in their interests to get it right.

The real question, and one over which we do have control, is the extent to which we should use our domestic tax arrangements to raise substitute revenue for that which may be lost by the oil price decline, and on the other hand to arrange taxes on oil or oil products which are designed to give the "right" signals to UK consumers. (I think we can rule out the possibility of a European Economic Community tax on imported oil, for obvious reasons. We are left then with simply domestic tax arrangements.)

If the fall in oil prices is known to be both steep and transitory, and it is known that the oil price will bounce back to even higher levels, as appears in all the Department of Energy forecasts, then there is a good case for transitory tax on oil products. This will stabilise revenue receipts and will do little or no harm to the planning of energy-consuming projects and lines of production.

If, however, the decline is seen to be both steep and permanent then it may be unwise to increase taxes on energy in order to make good revenue or to induce economies in energy consumption. We should allow the lower price of energy to be reflected in the market. Furthermore, there will be an automatic increase in the tax incidence on gasoline since the tax is fixed in money terms indexed to the

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/inflation rate;

inflation rate; and so as the price of oil falls and the final price falls, the tax will be an increasing fraction of the final price. This is a built-in increase in relative tax incidence. But these questions need further investigation.

However, to reiterate, none of these taxes would have any effect whatsoever on world oil prices and they would have a miniscule, probably unobservable effect on world production and consumption.

[My personal judgement is that we have only seen the first phase of the fall in the real price of oil. In the absence of political turmoil and dislocation in the Middle East, the fall, although not monotonic, will continue for some years. The expected breakdown in OPEC's quotas should see a sharp fall within a year.]

Conclusions

1. Although we can have no effect on world oil prices, it would be interesting to know D/Energy's view of their likely path for the next few years. [You may, however, take the view, as I do, that D/Energy's forecasts have been so bad they are worth little or no effort.]

2. The calculations of the consequences of a persistent low oil price, or of a low-then-high profile, need to be sharpened both logically and empirically (see my attached critique).

3. D/Energy and Treasury should work out the best tax regimes contingent on 2. above.

4. Confirm the policy of leaving the oil companies to determine their production levels.

AW

ALAN WALTERS
18 March 1983

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18 March 1983

ALAN WALTERS

CRITIQUE OF THE DEPARTMENT OF ENERGY NOTE:
THE OIL PRICE AND THE UK ECONOMY

Much of the first part of this note is concerned with predicting the advantages and disadvantages of a lower oil price on the UK economy. It does not much help as far as policy is concerned since we cannot control the oil price.

But some of the analysis seems to me to be wrong. The first error is to suggest that a lower oil price helps growth in an industrialised world. It doen't. It increases the level of real incomes. It is a step and does not affect growth per se. There would be a once-and-for-all increase and then a decline. But the rate of growth of output through time would not be affected by this step change. The nomenclature of "growth" is at least misleading.

Under para 3(ii) they seem to be suggesting that a lower sterling exchange rate due to the lower oil price would induce greater growth in the UK. This begs many questions about first the effect of the oil price change on the exchange rate, secondly the effect of the exchange rate on output of traded goods and non traded goods, and thirdly the effect of a relative price increase of traded goods on the absolute prices of labour and domestic resources. By the time I have got through this operation I have lost any impetus I once had. Is there anything left?

Under para 3(iii) they say it reduces world inflation. I cannot see why. It transfers real income to the oil consuming countries, mainly perhaps OECD countries. If they maintain their same monetary policies, then there will be a reduction in their price levels. Again, it's a once-and-for-all change and it has nothing to do with inflation. But if the oil exporting countries keep their monetary policy unchanged and suffer a reduction in real output, then their inflation rate will increase in the same proportion, if monetary policies are unchanged then I cannot see how it will affect the world price level or world inflation. Similarly, it is a non sequitur to say that the decisions taken by major governments after the Tokyo Summit not to accommodate the inflationary effects of the 1979 oil price increase caused inevitably a fall in the real price of oil. The decision to maintain more or less constant monetary and fiscal stances affects the nominal price level as a whole. The real price of oil is a consequence of demand and supply in the oil market, not of monetary policy.

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PRIME MINISTER

THE OIL PRICE AND THE UK ECONOMY

I attach a note by my Department which examines in some depth the implications of a falling oil price for the UK economy, and the question of our relations with OPEC. It would be helpful to have an early discussion of this paper by Ministers most closely concerned as a background to international discussions of the fall in the oil price and its policy implicatons, and to our own policy decisions.

2. The conclusions which I draw from the paper are as follows:-

(i) The moderate fall in the oil price which we have now seen will help world economic recovery but it is desirable both for the world and for the UK that the fall should go neither too fast nor too far. There is a real risk for the UK that the dynamics may be perverse, bringing in the adverse effects more rapidly than the benefits.

(ii) There is little the UK alone can do to ensure the fall is gradual. A link between ourselves and OPEC would probably be ineffective and would represent a major departure from our existing policies, risking a break in our links with the other industrial countries.

(iii) The successful pursuit of the Government's economic strategy requires that we maintain output and sales of North Sea oil. This is of great importance for revenue, PSBR and balance of payments reasons, and therefore also as part of the counter inflation policy. It is not in our interests to cut our oil production. Short of drastic action through new powers we lack the means to do so on any significant scale. And we cannot afford to undermine confidence in our readiness to rely on the market economy to develop North Sea oil by claiming to know better than the companies the balance of advantage between present and future production of the oil.

(iv) However, while it is beyond our power to do much to keep oil prices up we should not add to the pressures driving them down. Our stance should be one of acquiescing in downward market adjustments while keeping a low profile in relation to OPEC. We should do what we can to encourage a market psychology consistent with avoiding a sharp fall in the price.

3. I am copying this minute to the Chancellor of the Exchequer, the Secretaries of State for Foreign and Commonwealth Affairs, Industry and Trade, Sir Robert Armstrong and Mr Sparrow.

Secretary of State for Energy
16th March 1983

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THE OIL PRICE AND THE UK ECONOMY

Note by the Department of Energy

1. The purpose of this paper is first, to survey the implications of a falling oil price for the UK economy; secondly, to consider our relations with OPEC in the light of that survey; and finally, to look at the implications of this analysis for the line we might take in major international discussions in the coming months. The Department of Energy have been assisted by the Treasury in preparing the paper, but responsibility for the views expressed in it rests with the Department.

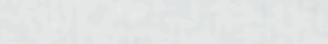
OIL AND THE UK ECONOMY

2. The advantages and disadvantages of a fall in the oil price for the UK economy can be summarised as follows:-

3. Advantages

(i) A lower oil price helps growth in the industrialised world. Rapid post-war growth was helped by cheap energy, and dear energy contributed to the recession. A lower oil price improves the terms of trade of the OECD countries and so raises the standard of living in industrial countries generally (but not the UK, see 4(ii) and (iii)). It operates like the removal of a tax. It is pure gain to economies like Germany and France which produce no oil, but consume much energy. It will help the US economy to grow and increase world trade. The OECD suggest that a 10% decline in oil prices would raise OECD growth by one third to a half

... per cent



per cent over the succeeding couple of years.

(ii) It means higher growth in the UK also. But because our exports are heavily weighted towards energy-producing and self-sufficient countries, the effect comes mainly from the lower sterling exchange rate which accompanies a lower oil price and the benefit might not be sustainable. If costs, especially wage costs, rise to offset the devaluation, the gain to competitiveness is lost after a time. The Treasury think that $5 off the oil price boosts our growth by one quarter to one half per cent a year over 2 years. But a falling exchange rate is a mixed blessing (see 4(iii) below).

(iii) It reduces world inflation. The fall in the oil price is indeed one of the consequences of the decisions taken by major Governments at and after the Tokyo Summit not to accommodate the inflationary effects of the 1979 oil price increase. A fall in the real oil price was inevitable as part of that process. The lower oil price, in itself, will help to reduce inflation in the UK, and operate in the opposite direction from the fall in the exchange rate. A 15% fall in the sterling oil price (equivalent at present to $5) could reduce UK prices by about 1%; but if the exchange rate falls the sterling price of oil would fall less - and other import prices could rise, at least partly offsetting the price reduction.

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(iv) It helps many developing countries. The development process is greedy of energy and most developing countries have less scope than developed ones for substitution or saving away from oil. Countries like Brazil, Pakistan and the Phillipines benefit substantially. Their actual or threatened debt problems are assisted. So, over a period, are those of Eastern Europe. These countries have more freedom to grow and less need to restrict.

(v) Lower oil prices will tend to put up the exchange rates of Japan and Germany. That may help the structure of world trade by reducing their tendency to flood the world with their exports. However, raising their exchange rates will further lower their inflation and their overall competitiveness may not be much affected beyond the very short term. For the UK, the benefits under this heading should not be double counted; they are the same benefits as those in (ii) above.

4. Disadvantages

(i) If the fall goes too far, it will halt most new energy investments, and reduce the momentum of conservation and fuel switching. Most observers believe that a fall to say $20 would boost the residual demand for OPEC oil by enough for OPEC to regain control over the price in a year or two. The price would then become vulnerable to political upheaval in OPEC countries. Oil markets could be pressing against capacity after about 4 years.

... over

(ii) Mexico and Venezuela are among the world's major debtor countries. Countries like Iraq and Indonesia also have heavy debts. Oil LDC's generally are bound to cut imports as well as drawing down financial reserves. There could be major new strains on the international banking and monetary system here and a major offset to increased growth. The UK, which exports disproportionately to oil producing countries and has a strong interest in the stability of the international banking system, could be adversely affected.

(iii) The overall terms of trade of the UK are worsened, both because the sterling exchange rate falls and because the UK is a net exporter of oil. This implies a longer term loss of national wealth. In the short term we enter a J curve and the current account of/the balance of payments deteriorates (even though the volume of net exports may rise).

(iv) The fall in the exchange rate is itself unhelpful to the counter inflation programme and there is room for doubt about whether the benefits of the oil price fall in reducing prices will come through more quickly than the price rises induced by the falling exchange rate. If the price rises come first, and if the exchange rate fall were large, then there could be a twist to wage and price expectations (especially if the PSBR were to be sharply boosted (see (v) below).

(v) The PSBR would be increased unless steps were taken to offset it. A major component of the Government's counter-inflation policy has been the application of North Sea

... tax

tax revenue to the reduction of the PSBR. The Government will not wish to see its achievement in reducing the PSBR eroded, but raising other taxes to offset losses of North Sea revenue would eliminate any direct output benefits (and probably any short-term inflation benefit too) from a lower oil price. The scale of the effect on the PSBR would vary with the extent of sterling depreciation against the dollar but a $5 price fall is unlikely to add less than three quarter billion pounds to the PSBR and it could be more than one and a half billion pounds. If the oil price falls sharply, either the exchange rate falls sharply also, when there is a large direct impact on prices, but the PSBR loss is mitigated; or the exchange rate falls less, when the direct impact on prices is mitigated but the PSBR loss is large.

5. Balance for the UK. It may be thought that because the sharp oil price increases of 1973/74 and 1979 were bad for the UK economy, any subsequent fall in prices must be helpful. But sharp changes in price, up or down, demand major adjustments, reflected in large changes in exchange rates, in revenue, in our external trading patterns and in the development of real incomes and living standards. The UK economy is less well adapted than others to respond quickly to sharp adjustments and that need for them is likely to impede the Government's medium term strategy.

6. Over a period of 2/3 years a moderate and gradual fall in the oil price is likely to be helpful to the UK economy. But a steep and fast fall could threaten the stability of the world financial system with damaging consequences

... for

for the recovery of world trade and economic growth. A temporarily low price followed by a bounce back could exacerbate the problems of structural adjustment and could lead to a mal-direction of new investments. At this stage in the counter-inflation programme we do not want to have to live through a sharp adjustment which, even within moderate monetary growth, could involve some build up of inflation flowing from the fall in the exchange rate. That could require a new effort to prevent a reversal of inflationary expectations and a reacceleration of wage increases which could turn the temporary effect on inflation into something more permanent.

7. Putting figures to this risks over-simplification. It may not be too far wrong to say that a $25 oil price would, if it came about by a sharp drop - especially if the market were not wholly convinced it had bottomed- create some awkward fiscal problems in the short term and might result in an undesirably sharp fall in sterling. It could therefore impose a sharp adjustment which it would be preferable to avoid. A fall to a $20 price or below would present even more serious problems. On the other hand a fall in the price to $25 in real terms which occurred gradually over 3 or 4 years e.g. as a result of inflation or a fall in the dollar, should present the UK with far fewer problems

8. UK Influence on Output and Prices. UK oil output, still less UK net exports, are not on a scale which can have a significant effect on the balance of world supply and demand. Any cut we could make would have minimal effects and be rapidly taken up by others. By contrast, US output at 8½m barrels a day is four times ours and Russian output is about 11m barrels. If however the UK were considering support for OPEC efforts to maintain prices and restrict production e.g. by parallel action, the Government would want to be satisfied that a chosen reduction in UKCS output really would be of benefit to the UK economy; and would need to take powers to

... enforce

enforce that reduction.

9. Although there are means by which the Government could try to have some influence on the level of output, that level is in practice controlled by the licensees. The Government would need to be on very strong ground if it were to impose its views about the level of production against their opposition, particularly in view of the assurances recently given that no such attempt would be made in the period up to 1985. There would be little prospect of securing the agreement of the companies to restrict output unless they were convinced that it was in their interests to sacrifice present income to achieve a better return in future. That would be a highly speculative proposition, and the chances of getting the many consortia of British and foreign companies which exploit the North Sea to accept such a proposition would be slight. Moreover, the attempt to influence them would undermine the confidence of the international oil industry in our readiness to rely on the market system for the development of North Sea oil. The Government have taken the view that the market system is the best way to exploit these resources and itwould hardly be in our long term interest to depart from that now.

10. Short of taking powers to override the assurances given on production levels, there are a number of possibilities (for example royalty oil banking, approach to profile variations and to new licence applications) which might eventually enable the Government to reduce the level of production somewhat , but most of them could only have an impact after some months or even years. It is not possible to be certain how effective these methods would be, especially if the companies were reluctant to cooperate. The Government would of course have to be confident that it had a better view than the companies about the prospective returns from delaying oil production. The Government would also have

... to be

to be prepared to accept postponement of North Sea revenue. Shutting in about 1/8th of North Sea production (about 0.3 mbd) for a year, would cost £1-1½ billions. Strictly as a cash trade-off, this would only be worth doing if it was thought that this scale of action by the UK could produce an oil price \$5 higher than it otherwise would be.

RELATIONS WITH OPEC

11. The conclusions in paragraphs 6 and 7 raises the question whether there is anything the UK can do to reduce the risk of a very sharp fall in the oil price. That in turn leads one to examine our relations with OPEC. Should the UK associate itself in some way with the efforts of OPEC to settle a new oil price? There have been indications that among non-OPEC producers the Mexicans have been inclined to move in this direction.

12. There is also a separate question about whether this is the time to initiate a new consumer/producer dialogue on oil price and supply. The European Parliament recently passed a resolution expressing concern about sharp fluctuations in oil prices; urging a dialogue with oil exporting countries and other consumers, with a view to preventing fluctuations in the oil price; and saying that it was essential to establish guaranteed long term prices for oil. Venezuela has already indicated n interest in a problem-sharing dialogue. It is unlikely however that there would be any serious support for so interventionist an approach from the United States or Germany.

13. On relations with OPEC, we have already made considerable efforts, with the help of BNOC, to pre-empt accusations from OPEC countries (especially Nigeria) that the UK was starting an oil price slide. The timing and scale of the recent BNOC proposal to reduce its price from \$33.50 to \$30.50 largely prevented such accusations. We have been very ready to listen

... courteously

courteously to visitors from OPEC countries and other oil producers, and to explain our position to them. The Saudis in particular understand that we do not control production, and that BNOC must follow the market.

14. An agreement with OPEC, formal or informal, would be a major change of policy. The objections to it can be summarised as follows:-

(i) OPEC would want us to restrict output, even though, as explained above, our output restrictions would have little effect on the world supply/demand balance: and the attempt to do so would undermine confidence in North Sea investment and cost us revenue. We need to sell North Sea output in the interests of the PSBR and of the balance of payments.

(ii) It is difficult to see what confidence we could have in an agreement with OPEC when OPEC has such great difficulty in agreeing among its own members. The odds are that if we cut output, even on a token basis, the shortfall would promptly be made up by countries like Iran, Libya or Venezuela which already have a reputation for disregarding OPEC agreements whenever it suits them. There simply is not a reliable partner for an agreement and there is certainly no reason why we should make sacrifices for OPEC. If OPEC can agree on an effective production programme, we are not needed; if it cannot, it is only in very unusual circumstances that our cooperation would provide the necessary cement.

(iii) Collaborating with OPEC to the point of restricting output would have implications for our relations with the United States and Europe. Hitherto we have identified

ourselves ..

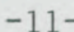
ourselves with the OECD countries on attitudes to OPEC and oil prices e.g. at the Tokyo and Venice Summits. A fall in price below say \$20-\$25 might require us to review our situation; but it would be very surprising if this led us to a policy which risked isolating us from the US and Europe.

(iv) There is the broad point that joining with OPEC to fix the oil price, or restrict output, would run clearly against the Government's market oriented approach.

15. The proposal for a consumer/producer dialogue, which would include an agreement on oil prices, is different because it presupposes an agreement among the major OECD countries . Those who propose a dialogue are not always clear about the content of an agreement and there is a risk that they would change their view if concrete proposals were made. In fact, if prices are to be stabilised. this "dialogue" also involves restriction of output and presumably part of that burden would fall on the UK. A larger part of the burden would have to be taken by US, since what would be involved would be a global commodity agreement implying control over oil markets. There is no prospect of the USA or Germany agreeing to this, particularly as real oil prices are still substantially above the \$17-\$18 of the spring of 1979. The UK could not initiate a consumer/producer dialogue and there is no clear indication of support for it, or organisation for it, on either side; or any advantage in raising false expectations about it.

NEW TAXES ON OIL

16. We may hear argument in industrial countries for increases in taxes on the consumption of oil or oil products so as to give the right long term signals to consumers about the oil price. If prices for oil were



raised by taxes, investment in other energy sources and in energy conservation in the countries concerned might be maintained at a higher level than otherwise, thus limiting the growth in oil consumption and reducing the risk of a price rebound in the world oil market. There would probably be argument that such action ought to be concerted between OECD or at least between Community countries so as to avoid adverse effects on the competitiveness of industry in particular countries.

17. In a weak oil market however extra oil taxation would drive prices to producers down yet further and would be seen by OPEC as confrontation. If adopted as a general policy it could help produce the steep and rapid price fall which would be against the UK interest. There therefore seems no case for support for it by the UK. Realistically it seems unlikely that such action will be concerted either in OECD or the Community. Some countries e.g.France or the US may take advantage of the scope they see in lower oil prices for raising consumption taxes, but that is likely to happen nationally rather than in concert.

INITIATIVES IN THE EUROPEAN COMMUNITY

18. An initiative to impose consumption taxes on the narrower base of the Community might have less impact on oil prices generally, but would adversely affect the competitiveness of EC exports including those from the UK. Non-oil energy and conservation investments in the Community would be protected but oilfield developments would not benefit. On the other hand, a Community wide oil import levy could hold some advantages for the UK in allowing UKCS oil to be sold at higher than world market prices in Europe. It could also help to redress the UK's EC budget contribution problem. Thus a concerted Community import levy could be preferable to increases in consumer oil taxes on a country by country basis.

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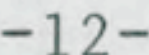

19. The alternative of a Minimum Support Price (or variable import levy) would be complex to administer and riddled with loopholes. Transfer prices of multinational oil companies would be manipulated to avoid levy. Countries like Libya would be very ready to manipulate both prices and invoices to avoid the levy and it would be to the advantage of Community oil importers to collude with them, so eroding North Sea market share. In practice, it is most unlikely that the Community would agree to a concerted oil import levy; meanwhile, we should refrain from being seen to be pushing for such a scheme which would be seen as confrontational by OPEC countries. If the notion of a European import levy or minimum support price were to emerge in the Community we should express interest and then in the various technical groups try to swing the proposals away from an MSP towards a Levy.

MARKET PSYCHOLOGY

20. At present the oil market is not rooted in the cost of production. Like the exchange market, it is a market much influenced by expectations. For example, talk of $7 cuts in the Gulf crude price, which is intended to frighten Nigeria, can prove partially self-fulfilling. The spot market is driven down by such talk and reacts on the term price market. Something can be done to reduce the risk of sharp price movements by refraining from over-emphasizing the possibilities of sharply falling prices and by stressing the factors likely in due course to underpin the market. There could be a slack oil market all through the Spring and Summer of 1983. There could however be some underpinning in the Autumn if the price prospect changes, provided OPEC maintains discipline and de-stocking ends. If the United States and European economies show significant growth in mid-year, that will help. Rigorous enforcement of existing oil stock obligations should apply. Comment ought to be directed towards these possibilities. If it is necessary to comment on the possibility of a sharp fall in the price, the

.... comment

comment should be that there is then likely to be a rebound later. These arguments would contribute something to helping the market during a weak mid-year period.

WILLIAMSBURG AND ELSEWHERE

21. Reactions to lower oil prices are bound to be discussed in various international fora (European Council, Williamsburg Summit etc). The line which would be helpful to the UK would be that the fall in the oil price that had already occurred was indeed favourable to world growth, but that further sharp falls would create problems and impose difficulties of adjustment. A fall which later led to another price surge because of the failure of energy investment and conservation would be very damaging. But improved growth should itself lead to some stabilisation of the market.

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Energy

MR WALTERS

ccs Mr Coles
Mr Scholar

THE OIL PRICE AND THE UNITED KINGDOM ECONOMY

I attach Mr Lawson's paper on this subject. I am arranging a meeting of Ministers to consider it next week, probably on Wednesday.

I wish that there was more numerical analysis in the paper, e.g. to demonstrate that the effect of a fall in the oil price on UK exports through restriction of demand from oil producers is sufficient to outweigh the increased demand from oil consumers, particularly the EEC countries and the United States; and that the harmful effect on inflation through the impact on the UK exchange rate exceeds the beneficial effect of the reduced oil price. These propositions are asserted, but we have to take the analysis in support of them for granted.

I take it that questions which Ministers will have to decide are whether they agree that

i) the UK's interest is a slowly declining real oil price, which presumably means trying to maintain the present nominal price over the next two to three years ?

ii) that we have no effective means of achieving it by limiting output or closer association with OPEC or trying to launch a consumer/producer dialogue, and that all we can do is to keep a low profile and try to keep reductions in BNOC's oil price as small as possible ?

iii) that it is not worth pursuing ideas of influencing domestic behaviour by a tax on oil consumption while the price is low, or of protecting BNOC oil prices by proposing

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an EEC levy on imported oil;

iv) that we should try to underpin the oil price by talking up the prospects of revived demand later the year.

I am sure that the Prime Minister would find it find it useful if you could find time to brief her on these points.

F.E.R.B.

16 March 1983

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ECN.O.

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

01-211-6402

Robin Butler Esq
Private Secretary to
the Prime Minister
10 Downing Street
London SW1

16 March 1983

Dear Robin,

THE OIL PRICE AND THE UK ECONOMY

My Secretary of State has today circulated his paper on this subject, as he undertook to do at the Prime Minister's meeting on 10 March.

He has asked me to say that he would be grateful if time could be found for it to receive an early discussion among Ministers. Now that OPEC has concluded its long meeting in London and the oil market has begun to assess the outcome, the Government will need to have agreed their position on the issues raised in the paper. Mr Lawson believes that this will be an important part of the background to a number of urgent decisions which are likely to arise in the near future. One of these decisions may indeed concern a further price adjustment by BNOC on which, in the light of the discussion of his paper, Mr Lawson would propose to consult the Prime Minister, Chancellor and Foreign Secretary in the usual way.

I am copying this letter to John Kerr (Treasury) and Brian Fall (FCO).

Yours ever,

J D WEST
Private Secretary

Energy : North Sea
Oil Prices
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TO PRIORITY F C O

TELEGRAM NUMBER 101 OF 15 MARCH 1983

AND TO PRIORITY WASHINGTON AND MEXICO CITY

SAVING TO KINGSTON, BRIDGETOWN, PORT OF SPAIN, SANTO DOMINGO, SAN JOSE, PANAMA CITY, TEGUCIGALPA, BELMOPAN AND BOGOTA

VENEZUELA/OPEC AND THE FINANCIAL SITUATION

1. THE O P E C AGREEMENT HAS BEEN RECEIVED WITH RESIGNATION IN MOST QUARTERS AS ANY FALL IN INCOME WILL EXACERBATE AN ALREADY DIFFICULT FISCAL SITUATION. BUT IT IS RECOGNISED THAT A PRICE COLLAPSE WOULD BE A DISASTER FOR VENEZUELA.

2. THE LIKELY PATTERN OF PRICE ADJUSTMENTS AND EXPORTS FOR THE REST OF 1983 ARE TOO IMPRECISE TO MAKE ACCURATE FORECASTS OF THE FINANCIAL EFFECT OF THE O P E C CHANGES ON VENEZUELA. THE FIGURE OF A FALL IN OIL EARNINGS OF UP TO DOLLARS 3 BILLION FROM THE OFFICIAL DOLLARS 16 BILLION ESTIMATE, (MY TELNO 28 OF 28 JANUARY) STILL STANDS AS OUR BEST ESTIMATE.

3. VENEZUELA IS CURRENTLY PRODUCING SLIGHTLY LESS THAN 2.0 MILLION B/D WITH EXPORTS AT 1.5 MILLION B/D. THERE HAS BEEN A BUILD UP OF STOCKS IN RECENT MONTHS AND VENEZUELA WILL TRY TO KEEP EXPORTS UP BY DRAWING THEM DOWN. THEY CAN DO THIS AT THE RATE OF 80-100 THOUSAND B/D FOR AT LEAST A QUARTER. A PRODUCTION QUOTA OF 1.7 MILLION B/D IMPLIES EXPORTS AFTER LOCAL CONSUMPTION OF ABOUT 1.4 MILLION B/D. WITH STOCK DRAW DOWN VENEZUELA WILL PROBABLY TRY TO KEEP AS CLOSE TO 1.5 MILLION B/D EXPORTS AS THE MARKET WILL BEAR.

4. AS A SIGN OF THE TIMES, THE VENEZUELAN INVESTMENT FUND DECIDED ON 14 MARCH TO SUSPEND ALL CENTRAL AMERICAN AND CARIBBEAN AID PROGRAMMES. IT IS UNCLEAR WHETHER THIS EXTENDS TO THE VENEZUELAN/ MEXICAN OIL FACILTY BUT IT MUST BE AT RISK.

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5. THE GENERAL FINANCIAL/ECONOMIC SITUATION REMAINS CONFUSED, WITH LACK OF DIRECTION ON THE APPLICATION OF THE VARIOUS EXCHANGE CONTROL MEASURES ANNOUNCED ON 23 FEBRUARY. IN ADDITION TO LACK OF ADMINSTRATIVE COORDINATION, THERE ARE STILL FUNDAMENTAL DISAGREEMENTS WITHIN THE GOVERNMENT ON HOW THE SITUATION SHOULD BE HANDLED, WITH THE CENTRAL BANK GOVERNOR, DIAZ BRUZUAL, AT ODDS WITH THE FINANCE MINISTER ARTURO SOSA. THIS PARTICULARLY APPLIES TO THE TREATMENT OF PRIVATE DEBT UNDER THE EXCHANGE CONTROL SYSTEM, BUT THERE IS ALSO IMPRECISION OVER WHICH IMPORT CATEGORIES ARE TO BE GIVEN PREFERENTIAL EXCHANGE TREATMENT. THE LIST OF BANNED IMPORTS STILL HAS NOT ISSUED.

F C O PLEASE PASS SAVING TO KINGSTON, BRIDGETOWN, PORT OF SPAIN, SANTO DOMINGO, SAN JOSE, PANAMA CITY, TEGUCIGALPA, BELMOPAN AND BOGOTA.

CARLESS

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OO JEDDA DESKBY 121245Z
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PRIME MINISTER'S
PERSONAL MESSAGE
SERIAL No. T29/83

GRS 619
CONFIDENTIAL
DESKBY JEDDA AND RIYADH 121245Z
FM FCO 121145Z MARCH 83
TO IMMEDIATE JEDDA
TELEGRAM NUMBER 123 OF 12 MARCH
INFO IMMEDIATE RIYADH
MIPT : MESSAGE TO KING FAHD

1. FOLLOWING IS TEXT OF MESSAGE: BEGINS: I WRITE TO THANK YOUR MAJESTY FOR YOUR PERSONAL MESSAGE ABOUT THE PRESENT OIL PRICE SITUATION. I MUCH APPRECIATED THE WAY IN WHICH SHEIKH YAMANI BRIEFED THE SECRETARY OF STATE FOR ENERGY, MR LAWSON, WITH SUCH FRANKNESS AND CLARITY ABOUT DEVELOPMENTS AT THE OPEC MEETING IN LONDON.

2. IT IS CERTAINLY NO PART OF THE POLICY OF THE UNITED KINGDOM GOVERNMENT TO TAKE ACTION WHICH MIGHT DESTABILISE THE WORLD OIL MARKET. IN THE INTERESTS OF THE HEALTH OF THE ECONOMY OF THE FREE WORLD WE HAVE WELCOMED A REDUCTION IN INTERNATIONAL OIL PRICES BELOW THE DOLLARS 34 LEVEL, ESPECIALLY AT A TIME WHEN THE US DOLLAR REMAINED STRONG. I BELIEVE THAT THE VIEWS OF THE KINGDOM OF SAUDI ARABIA AND THE UNITED KINGDOM ON THIS HAVE BEEN VERY SIMILAR. WE ALSO SHARE YOUR INTEREST IN AVOIDING A FURTHER SHARP FALL IN PRICES. WE JUDGE THAT THAT WOULD BE CONTRARY TO THE INTERESTS OF THE FREE WORLD, AS WELL AS TO THE INTERESTS OF OUR TWO COUNTRIES. SO I SEE MUCH IDENTITY OF VIEW AND INTEREST BETWEEN US.

3. AFTER THE GENEVA OPEC MEETING THE BRITISH NATIONAL OIL CORPORATION DELAYED ANY IMMEDIATE REDUCTION IN ITS PRICES. SUBSEQUENTLY, ALTHOUGH ITS ROOM FOR MANOEUVRE IS VERY LIMITED, BNOC RESTRICTED THE PRICE REDUCTION IT PROPOSED TO A LEVEL CONSISTENT WITH THE RE-ESTABLISHMENT OF THE ARAB LIGHT MARKER AT DOLLARS 30 A BARREL.

4. HOWEVER, AS MR LAWSON HAS EXPLAINED TO SHEIKH YAMANI, THE

BRITISH GOVERNMENT DOES NOT CONTROL THE LEVEL OF PRODUCTION OF OIL IN THE UNITED KINGDOM, OR THE PRICE AT WHICH IT IS SOLD, ANY MORE THAN THE US GOVERNMENT CONTROLS THESE MATTERS IN THE UNITED STATES. THE BRITISH NATIONAL OIL CORPORATION HAS UNDER THE LAW ONLY A LIMITED ROLE AS A TRADER IN OIL AND THEREFORE HAS TO NEGOTIATE A PRICE FOR ITS OIL WHICH IS ACCEPTABLE TO BOTH ITS SUPPLIERS AND ITS CUSTOMERS.

5. IF IT WERE TO TRY TO DISREGARD THE POSITION IN THE MARKET - WHICH REFLECTS DEVELOPMENTS IN THE UNITED STATES AND THE BEHAVIOUR OF THE SOVIET UNION, AS WELL AS THE DECISIONS TAKEN BY OPEC - AND SEEK TO IMPOSE A HIGHER PRICE THAN THE MARKET WILL BEAR, THE ONLY EFFECT WOULD BE LOSS OF ITS CUSTOMERS AND A REQUIREMENT TO DISPOSE OF INCREASING VOLUMES OF OIL IN THE SPOT MARKET. THAT IN ITS TURN WOULD PUT FURTHER DOWNWARD PRESSURE ON WORLD PRICES, AND UNDERMINE THE EFFORT TO RE-ESTABLISH STABLE CONDITIONS.

6. NEVERTHELESS I RECOGNISE THE VERY GREAT EFFORTS THE OPEC MEMBER COUNTRIES HAVE MADE TO REACH AN AGREEMENT WHICH WILL STEADY THE MARKET. THE BRITISH GOVERNMENT WILL SAY NOTHING TO CAST DOUBT ON THAT AGREEMENT. SHEIKH YAMANI HAS BEEN IN TOUCH WITH MR LAWSON WHO HAS EXPLAINED THAT WE WILL DO WHAT WE CAN TO HELP. THE BNOC WILL REFRAIN FROM MAKING ANY IMMEDIATE MOVE FOLLOWING AN EARLY ANNOUNCEMENT OF AN OPEC AGREEMENT. IT WILL PERMIT ITS CUSTOMERS TO MAKE REPRESENTATIONS, IF THEY SO DECIDE, ON ITS EARLIER PROPOSAL OF DOLLARS 30.50 A BARREL AND WILL CONSIDER THOSE REPRESENTATIONS BEFORE MAKING ANY FURTHER MOVE. IT WILL THEN SEEK TO NEGOTIATE THE HIGHEST POSSIBLE PRICE FOR ITS OIL, AGAINST THE BACKGROUND OF THE IMPACT ON THE MARKET OF THE OPEC DECISIONS.

7. I HOPE THAT OUR TWO COUNTRIES WILL CONTINUE TO KEEP IN TOUCH ON THIS AND THE MANY OTHER IMPORTANT ECONOMIC AND POLITICAL QUESTIONS THAT CURRENTLY AFFECT THE INTERESTS OF OUR TWO COUNTRIES AND INDEED OF THE WHOLE WORLD. IN THIS CONNEXION, I AM LOOKING FORWARD TO SEEING HIS ROYAL HIGHNESS PRINCE SAUD AL FAISAL AS PART OF THE ARAB LEAGUE DELEGATION WHICH IS TO VISIT LONDON ON 18 MARCH. ENDS.

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p.a.

GRS 124
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DESKBY 121245Z JEDDA RIYADH
FM FCO 121130Z MARCH 83
TO IMMEDIATE JEDDA,
TELEGRAM NUMBER 122 OF 12 MARCH 1983,
INFO IMMEDIATE RIYADH.
MESSAGE TO KING FAHD

1. MIFT CONTAINS THE TEXT OF THE PRIME MINISTER'S REPLY TO KING FAHD. PLEASE DELIVER THIS TO KING FAHD AS SOON AS POSSIBLE.

2. IT HAS BEEN DRAFTED AS A WRITTEN MESSAGE FROM THE PRIME MINISTER TO THE KING AND THE TEXT HAS BEEN CAREFULLY DRAFTED IN WHITEHALL FOLLOWING MINISTERIAL DISCUSSION. IT IS IMPORTANT THAT THE SUBSTANCE BE DELIVERED AS DRAFTED. HOWEVER, GIVEN THE WAY IN WHICH KING FAHD'S MESSAGE TO THE PRIME MINISTER WAS DELIVERED, YOU HAVE DISCRETION TO DELIVER HER REPLY ORALLY IF YOU THINK IT MORE APPROPRIATE. BUT IN THAT CASE YOU SHOULD LEAVE A WRITTEN TRANSLATION OF THE TEXT.

PYM

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Energy
North Sea Oil

File 1

PRIME MINISTER

I attach a draft of the paper on oil prices being prepared by Mr Lawson, which was mentioned at his meeting with you yesterday. The draft is not yet in final form.

The paper is informative, but does not require any decisions, beyond those taken last night. I suggest that the best time to have a further collective discussion would be when BNOC have got some reactions from their customers to the OPEC agreement and Ministers can take a view on what should happen to their term price of $30.5 after 21 March. It would be convenient to have such a meeting on this coming Thursday i.e. the day before the visit of the Arab League, but I doubt whether there is much point in doing so unless sufficient evidence has accumulated by then to enable a view to be formed on the next move in the BNOC price.

Agree that we should fix a further collective meeting adding the Secretaries of State for Trade and Industry to the group which met yesterday when the stage is reached of being able to take a view on the next movement in the BNOC price?

Yes - but we shall almost certainly have a brief discussion at Cabinet on Tuesday. MT

F.E.R.B.

11 March 1983

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

F G R Butler Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON SW1

11 March 1983

Dear Robin,

I attach a copy, for your own use, of the draft note on the oil price and the UK economy which you discussed last night with Julian. This has not been approved or even seen by the Secretary of State. He has it in mind that it might be discussed by the Prime Minister, the Foreign Secretary, the Chancellor and himself, and possibly the Secretaries of State for Trade and Industry.

Yours sincerely

C E Brooks

MISS C E BROOKS
Private Secretary

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THE OIL PRICE AND THE UK ECONOMY

Note by the Department of Energy.

1. The purpose of this paper is first, to survey the implications of a falling oil price for the UK economy; secondly, to consider our relations with OPEC in the light of that survey; and finally, to look at the implications of this analysis for the line we might take in major international discussions in the coming months. The Department of Energy have been assisted by the Treasury in preparing the paper, but responsibility for the views expressed in it rests with the Department.

F.C.O.?

Oil and the UK economy

2. The advantages and disadvantages of a fall in the oil price for the UK economy can be summarised as follows:-

3. Advantages

(i) A lower oil price helps growth in the industrialised world. Rapid post-war growth was helped by cheap energy, and dear energy contributed to the recession. A lower oil price improves the terms of trade of the OECD countries and so raises the standard of living in industrial countries generally (but not the UK, see 4(ii) and (iii)). It operates like the removal of a tax. It is pure gain to economies like Germany and France which produce no oil, but consume much energy. It will help the US economy to grow and increase world trade. The OECD suggest that a 10% decline in oil prices would raise OECD growth by

one third

one third to a half per cent over the succeeding couple of years.

(ii) It means higher growth of the UK also. But because our exports are heavily weighted towards energy producing and self-sufficient countries, the effect comes mainly from the lower sterling exchange rate which accompanies a lower oil price and the benefit may not be sustainable. If costs, especially wage costs, rise to offset the devaluation, the gain to competitiveness is lost after a time. The Treasury think that $5 off the oil price boosts our growth by one quarter to one half per cent a year over 2 years. But a falling exchange rate is a mixed blessing (see 4(iv) below).

(iii) It reduces world inflation. The fall in the oil price is indeed part of the counter inflationary process set in motion by the major Governments at the Tokyo Summit. A fall in the real oil price was inevitable as part of that process. The lower oil price, in itself, will help to reduce inflation in the UK, and operate in the opposite direction from the fall in the exchange rate. A 15% fall in the sterling oil price (equivalent at present to $5) could reduce UK prices by about 1%; but if the exchange rate falls the sterling price of oil would fall less - and other import prices could rise, at least partly offsetting the price reduction.

...over

(iv) It helps many developing countries. The development process is greedy of energy and most developing countries have less scope than developed ones for substitution or saving away from oil. Countries like Brazil, Pakistan, the Phillipines and Korea benefit substantially. Their actual or threatened debt problems are assisted. So, over a period, are those of Eastern Europe. These countries have more freedom to grow and less need to restrict. It reduces Russia's power as a net exporter.

(v) Lower oil prices will tend to put up the exchange rates of Japan and Germany. That may help the structure of world trade by reducing their tendency to flood the world with their exports. However, raising their exchange rates will further lower their inflation and their overall competitiveness may not be much affected beyond the very short term. For the UK, the benefits under this heading should not be double counted; they are the same benefits as those in (ii) above.

4. Disadvantages

(i) If the fall goes too far, it will halt most new energy investments, and reduce the momentum of conservation and fuel switching. Most observers believe that a fall to say $20 would boost the residual demand for OPEC oil by enough for them to retain control over the price in a year or two. Oil markets could be pressing against capacity - making the price vulnerable to shocks - within 4 - 6 years.

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(ii) Mexico and Venezuela are among the world's major debtor countries. Countries like Iraq and Indonesia also have heavy debts. Oil LDC's generally are bound to cut

imports as well as drawing down financial reserves. Ther could be major new strains on the international banking and monetary sytem here and a major offset to increased growth. The UK, which exports disproportionately to oil producing countries and has a strong interest in the stability of the international banking system, could be adversely affected.

(iii) The overall terms of trade of the UK are worsened, both because the sterling exchange rate falls and because the UK is a net exporter of oil. This implies a longer term loss of our economic capacity. In the short term we enter a J curve and the current account of balance of payments deteriorates (even though the volume of net exports may rise).

(iv) The fall in the exchange rate is itself unhelpful to the counter inflation programme and there is room for doubt about whether the benefits of the oil price fall in reducing prices will come through more quickly than the price rises induced by the falling exchange rate. If this were to happen, and if the exchange rate fall were large, then there could be a twist to wage and price expectations (especially if the PSBR were to be sharply boosted (see (v) below).

(v) The PSBR would be increased unless steps were taken to offset it. The scale of the increase would vary with the size of the fall in sterling against the dollar - but a $5 fall in price is unlikely to add less than three quarter billion pounds to the PSBR and it could be more than one and a half billion pounds. As a broad rule, a rise in the oil price is favourable

to the public sector and a fall is favourable to the private sector. The marginal rate of oil taxation is so high that the biggest loser from a fall in the price is the Government. A fall in the exchange rate will help to maintain the sterling value of oil revnues if they decline in dollar terms, but unless sterling depreciates faster than the oil price, the real value of these revenues will be less. The long term revenue prospect for the future is reduced because development becomes less attractive.

5. Balance for the UK

Over a period of 2/3 years a moderate and gradual fall in the oil price is likely to be helpful to the UK economy. But a steep and fast fall could threaten the stability of the world financial system with damaging consequences for the recovery of world trade and economic growth. A temporarily low price followed by a bounce back could exacerbate the problems of structural adjustment and could lead to a mal-direction of new investments. At this stage in the counter inflation programme we do not want to have to live through a sharp adjustment which, even within moderate monetary growth, could involve some build up of inflation flowing from the fall in the exchange rate. That could require a new effort to prevent a reversal of inflationary expectations and a reacceleration of wage increases which could turn the temporary effect on inflation into something more permanent.

6. Putting figures to this risks over-simplication. It may not be too far wrong to say that $25 oil price would, if it came about by a sharp drop - especially if the market were not wholly convinced it had bottomed - create some awkward fiscal problems in the short term and might result in an undesirably sharp fall in sterling. It could therefore impose a sharp adjustment which it would be

preferable to avoid. A fall to a $20 price or below would present even more serious problems. On the other hand a fall in the price to $25 in real terms which occurred gradually over 3 or 4 years e.g. as a result of inflation or a fall in the dollar, should present the UK with far fewer problems.

7. UK Influence on Output and Prices

An essential theme of this paper is that although BNOC may on occasion have been incorrectly seen as playing a price leadership role, in practice the UK has no effective market power in fixing the level of world oil prices. If there were any question of UK becoming part - whether explicitly or by means of parallel action to restrain production - of an OPEC effort to maintain oil prices at artificially high levels, action would require the Government:-

(i) to be satisfied that a given reduction in the output of the UKCS would be of benefit to the UK economy, and

(ii) to take powers to enforce that reduction in output.

8. As emerges from the next section of this paper, it is doubtful whether such action could ever be effective. However, even if action were open to the Government, it is doubtful whether the case for it would be sustained. In practice the rate of output from UKCS fields is controlled by the licensees, and the Government would need to be on very strong ground if it were to impose its views on the appropriate level of production against their opposition. To attempt this would require confidence on the part of the Government that oil left in the ground would now be worth sufficiently more in future to outweigh the current loss of income and the continuing interest burden in the intervening period resulting from the need for additional borrowing to replace that income. It is just possible, in the event of a fall in the price to less than $20 a barrel, that differences in the rate at which future income and expenditure are

discounted might lead licensees to continue production at a time when the Government considered cutting back to the preferable course. However, such a situation seems very unlikely to arise in the near future.

Relations with OPEC

9. The conclusion in paragraphs 5 and 6 raises the question whether there is anything the UK can do to reduce the risk of a very sharp fall in the oil price. That in turn leads one to examine our relations with OPEC. Should the UK associate itself in some way with the efforts of OPEC to settle a new oil price? There have been indications that among non-OPEC producers the Mexicans have been inclined to move in this direction.

10. There is also a separate question about whether this is the time to initiate a new consumer/producer dialogue on oil price and supply. The European Parliament recently passed a resolution expressing concern about sharp fluctuations in oil prices; urging a dialogue with oil exporting countries and other consumers, with a view to preventing fluctuations in the oil price; and saying that it was essential to establish guaranteed long term prices for oil. Venezuela has already indicated an interest in a problem-sharing dialogue. It is unlikely however that there would be any serious support for so interventionist an approach from the United States or Germany or even from France.

11. On relations with OPEC, we have already made considerable efforts, with the help of BNOC, to pre-empt accusations from OPEC countries (especially Nigeria) that the UK was starting an oil price slide. The timing and scale of the recent BNOC proposal to reduce its price from \$33.50 to \$30.50 largely prevented such accusations. We have been very ready to listen courteously to visitors from OPEC countries and other oil producers, and to explain our position to them. The Saudis in particular understand that we do not control production, and that BNOC must follow the market.

12. An agreement with OPEC, formal or informal, would however be a major change of policy. The objections to it include the following:-

(i) OPEC would want us to restrict output, even though our output restrictions would of themselves have little effect on the world supply/demand balance. With some difficulty and much persuasion we might in fact be able to have some limited effect on output, but in the main the position is that we cannot control it. The attempt to do so would undermine confidence in investment in the North Sea and would cost us revenue. We need to sell North Sea output in the interests of the PSBR and of the balance of payments.

(ii) It is difficult to see what confidence we could have in an agreement with OPEC when OPEC has such great difficulty in agreeing among its own members. In practice, the odds are that if we cut output, even on a token basis, the shortfall would promptly be made up by countries like Iran, Libya or Venezuela which already have a reputation for disregarding OPEC agreements whenever it suits them. There simply is not a reliable partner for an agreement. If OPEC can agree on an effective production programme, we are not needed; if it cannot, it is only in very unusual circumstances that our cooperation would provide the necessary cement.

(iii) Collaborating with OPEC to the point of restricting output would have implications for our relations with the United States and Europe. Hitherto we have identified ourselves with the OECD countries on attitudes to OPEC and oil prices e.g. at the Tokyo and Venice Summits. A fall in price below say $20-25 might require us to review our

situation; but it would be very surprising if this led us to a policy which risked isolating us from the US and Europe.

(iv) There is the broad point that joining with OPEC to fix the oil price, or restrict output, would run clearly against the Government's market oriented approach.

13. The proposal for a consumer/producer dialogue, which would include an agreement on oil prices, is different because it presupposes an agreement among the major OECD countries. If prices are to be maintained it too involves restriction of output and presumably part of that burden would fall on the UK. A larger part of the burden would have to be taken by the US, since what would be involved would be a global commodity agreement implying control over oil markets. There is no prospects of the USA or Germany agreeing to this, particularly as real oil prices are still substantially above the $17-$18 of the spring of 1979. The UK could not initiate a consumer/producer dialogue and there is no clear indication of support for it, or organisation for it, on either side.

New taxes on oil

14. We may hear argument in industrial countries for increases in taxes on the consumption of oil or oil products so as to give the right long term signals to consumers about the oil price. If prices for oil were raised by taxes, investment in other energy sources and in energy conservation in the countries concerned might be maintained at a higher level than otherwise, thus limiting the growth in oil consumption and reducing the risk of a price rebound in the world oil market. There would probably be argument that such action ought to be concerted between OECD or at least between Community countries so as to avoid adverse effects on the competitiveness of industry in particular countries.

15. In a weak oil market however extra oil taxation would drive prices to producers down yet further and would be seen by OPEC as confrontation. If adopted as a general policy it could well help to produce the steep and rapid price fall which would be against the UK and the wider interest. There therefore seems no case for support by the UK for such action. Realistically it seems unlikely that such action will be concerted either in the OECD or the Community. Some countries e.g. France may take advantage of the scope they see in lower oil prices for raising consumption taxes, but that is likely to happen nationally rather than in concert.

Initiatives in the European Community

16. An initiative on the narrower base of the Community would have less disadvantage in terms of its effect on the overall energy price though some would still remain. Non-oil energy and conservation investments in the Community would be protected but at the price of some loss of competitiveness of energy consuming industries. It is doubtful whether new oil field developments would be protected because the oil companies would have little confidence in the durability of such a scheme. A Community wide oil import levy could hold some advantages for the UK in allowing UKCS oil to be sold at higher prices in Europe and there could be budgetary advantages. A concerted Community import levy could therefore be preferable to an increase in consumer oil taxes on a country by country basis. A Minimum Support Price (or variable import levy) would however be complex to administer and there would be loopholes. Because UKCS prices are transparent, whereas many other oil producers' prices are not, there could be discrimination against North Sea oil. Realistically it is unlikely that the Community will agree to a concerted oil import levy and we should refrain from being seen to be pushing for such a scheme because that would seem doubly confrontational to OPEC countries. If the notion of a European import levy or minimum support prices does emerge in the Community

we should respond constructively and in the various technical groups we should try to swing the proposals away from an MSP towards a Levy.

Market psychology

17. At present the oil market is not rooted in the cost of production. Like the exchange market, it is a market much influenced by expectations. For example, talks of $7 cuts in the Gulf crude price, which is intended to frighten Nigeria, can prove partially self-fulfilling. The spot market is driven down by such talk and reacts on the term price market. Something can be done to reduce the risk of sharp price movements by refraining from over-emphasizing the possibilities of sharply falling prices and by stressing the factors likely in due course to underpin the market. There could be a slack oil market all through the Spring and Summer of 1983. There could however be some underpinning in the Autumn if the price prospect changes, provided OPEC maintains discipline and de-stocking ends. If the United States and European economies show significant growth in mid-year, that will help. Rigorous endorsement of existing oil stock obligations should apply. Comment ought to be directed towards these possibilities. If it is necessary to comment on the possibility of a sharp fall in the price, the comment should be that there is then likely to be a rebound later. These arguments would contribute something to helping the market during a weak mid-year period.

Williamsburg and elsewhere

18. Reactions to lower oil prices are bound to be discussed in various international fora (European Council, Williamsburg Summit etc). Prices may stabilise, but the market may still be fragile. The line which would be helpful to the UK would be that the fall in the oil price that had already occurred was indeed favourable to world growth, but that further sharp falls would create problems and impose

difficulties of adjustment. A fall which later led to another price surge because of the failure of energy investment and conservation would be very damaging. But improved growth should itself lead to some stabilisation of the market.

Conclusions

(i) A moderate fall in the oil price will help economic recovery but it is desirable both for the world and for the UK that the fall should be neither too fast nor too far. There is some risk for the UK that the dynamics may be perverse bringing in the inflationary effects more rapidly than the benefits in reduced prices.

(ii) Although we would like to avoid too swift or steep a fall in the oil price, there is little we can do to ensure the fall is gradual. A link between ourselves and OPEC would probably be ineffective and would represent a major departure from our existing policies and risk a break in our links with the other industrial countries.

(iii) The successful pursuit of the Government's economic strategy requires that we maintain output and sales of North Sea oil. This is of great importance for revenue and balance of payment reasons, and therefore also as part of the counter inflation policy. It is not in our interests to cut our oil production and we effectively lack the means to do so on any significant scale.

(iv) However, while it is beyond our power (and contrary to our interests) to do much to keep oil prices up we should not add to the pressures driving them down. Our stance should be one of reluctantly acquiesing in downward market adjustments while keeping as low a profile as possible in relation to OPEC. We should do what we can to encourage a market psychology consistent with avoiding a sharp fall in the price.

1 MAR 1983

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PRIME MINISTER

OPEC: Message to King Fahd

I attach a message to King Fahd which has been cleared with all concerned.

If you agree with it, I think it would be a good idea to despatch it on Saturday. The Duty Clerk will do this. The FCO tell me that King Fahd's message was delivered orally to Sir James Craig by the King's Chief of Protocol. Unless you object the FCO will give James Craig discretion to deliver your message orally as well if he feels that is the way the King would prefer it.

I also attach a note of Mr. Lawson's conversations with Sheikh Yamani on 10 March.

A.J.C.

11 March 1983

MESSAGE TO KING FAHD

I write to thank Your Majesty for your personal message about the present oil price situation. I much appreciated the way in which Sheikh Yamani briefed the Secretary of State for Energy, Mr. Lawson, with such frankness and clarity about developments at the OPEC meeting in London.

It is certainly no part of the policy of the United Kingdom Government to take action which might destabilise the world oil market. In the interests of the health of the economy of the free world we have welcomed a reduction in international oil prices below the $34 level, especially at a time when the US dollar remained strong. I believe that the views of the Kingdom of Saudi Arabia and the United Kingdom on this have been very similar. We also share your interest in avoiding a further sharp fall in prices. We judge that that would be contrary to the interests of the free world, as well as to the interests of our two countries. So I see much identity of view and interest between us.

After the Geneva OPEC meeting the British National Oil Corporation delayed any immediate reduction in its prices. Subsequently, although its room for manoeuvre is very limited, BNOC restricted the price reduction it proposed to a level consistent with the re-establishment of the Arab light marker at $30 a barrel.

However, as Mr. Lawson has explained to Sheikh Yamani, the British Government does not control the level of production of oil in the United Kingdom, or the price at which it is sold, any more than the US Government controls these matters in the United States. The British National Oil Corporation has under the law only a limited role as a trader in oil and therefore has to negotiate a price for its oil which is acceptable to both its suppliers and its customers.

If it were to try to disregard the position in the market - which reflects developments in the United States and the behaviour of the Soviet Union, as well as the decisions taken by OPEC -

/ and

and seek to impose a higher price than the market will bear, the only effect would be loss of its customers and a requirement to dispose of increasing volumes of oil in the spot market. That in its turn would put further downward pressure on world prices, and undermine the effort to re-establish stable conditions.

Nevertheless I recognise the very great efforts the OPEC member countries have made to reach an agreement which will steady the market. The British Government will say nothing to cast doubt on that agreement. Sheikh Yamani has been in touch with Mr. Lawson who has explained that we will do what we can to help. The BNOC will refrain from making any immediate move following an early announcement of an OPEC agreement. It will permit its customers to make representations, if they so decide, on its earlier proposal of $30.50 a barrel and will consider those representations before making any further move. It will then seek to negotiate the highest possible price for its oil, against the background of the impact on the market of the OPEC decisions.

I hope that our two countries will continue to keep in touch on this and the many other important economic and political questions that currently affect the interests of our two countries and indeed of the whole world. In this connection, I am looking forward to seeing His Royal Highness Prince Saud Al Faisal as part of the Arab League Delegation which is to visit London on 18 March.

10 DOWNING STREET

Mr. Walters

We spoke. Grateful if you would return this with any comments as soon as possible.

For reasons I explained, it would be helpful if you did not discuss the message with people outside No. 10!

A.J.C. 11/3.

Mr Coles

Only a few words — nothing of substance

AW

010

DEPARTMENT OF ENERGY
THAMES HOUSE SOUTH
MILLBANK
LONDON SW1P 4QJ

01-211 4391

SIR KENNETH COUZENS KCB
PERMANENT UNDER-SECRETARY OF STATE

11th March 1983

Dear John

DRAFT REPLY TO KING FAHD

As arranged, I attach a redraft in the form in which I have sent it to Peter Middleton and Richard Evans. I will do my best to let you have the final version (or telephone amendments to this one) by 4.30 p.m.

Yours ever

Ken

A.J. Coles, Esq.
Private Secretary
No. 10 Downing Street

DRAFT MESSAGE TO KING FAHD

I ~~would like to send my~~ write to thank Your Majesty ~~thanks to you~~ for your personal message about the present oil price situation. I ~~have also~~ much appreciated the way in which Sheikh Yamani ~~has~~ briefed ~~my~~ the Secretary of State for Energy, Mr. Lawson, with such frankness and clarity about developments at the OPEC meeting in London.

It is certainly no part of the policy of the United Kingdom Government to take action which might destabilise the world oil market. In the interests of the health of the ~~world~~ the economy ~~and of lower inflation~~ of the free world we have welcomed a reduction in international oil prices below the $34 level, especially at a time when the U.S. dollar remained strong. I believe that the views of ~~your country~~ the Kingdom of Saudi Arabia and ~~mine~~ of the United Kingdom on this have been very similar. ~~But~~ We also share ~~your~~ our interest in avoiding a further ~~sudden and~~ sharp fall in prices. We judge that that would be contrary to the interests of the free world ~~economy~~, as well as to the interests of ~~your country and mine~~ our two countries. So I ~~perceive~~ see much identity of view and interest between us.

After the Geneva OPEC meeting the British National Oil Corporation~~, despite very strong market pressure,~~ delayed any immediate reduction in its prices. Subsequently, although its room for manoeuvre is very limited, BNOC restricted the price reduction it proposed to a level ~~which would have been~~ consistent with the re-establishment of the Arab light marker at $30 a barrel.

However, as ~~my Secretary of State for Energy~~ Mr. Lawson has explained to Sheikh Yamani, the British Government does not control the

level ~~rate~~ of production of oil in the United Kingdom, or the price at which it is sold, any more than the US Government controls these matters in the United States. The British National Oil Corporation has under the law only a limited role as a trader in oil and therefore it has to ~~and has, if it is to discharge that role, to~~ negotiate a price for its oil which is acceptable to both its suppliers and its customers.

If it were to try to disregard the position in the market - which reflects developments in the United States and the behaviour of the Soviet Union, as well as the decision ~~the conclusions reached by~~ taken by OPEC - and seek to impose a higher price than the market will bear, the only effect would be loss of its customers and a requirement to dispose of increasing volumes of oil in the spot market. That in its turn would put further downward pressure on world prices, and undermine the effort to re-establish stable conditions.

Nevertheless I recognise the very great efforts the OPEC member countries have made to reach an agreement which will steady the market. The British Government will say nothing to cast doubt on that agreement. Sheikh Yamani has been in touch with Mr. ~~Nigel~~ Lawson who ~~and Mr. Lawson~~ has explained that we will do what we can to help. The BNOC will refrain from making any immediate move following an early announcement of an OPEC agreement. It will permit~~s~~ its customers to make representations, if they so decide, on its earlier proposal of $30.50 a barrel and will consider those representations before making any further move. It will then seek to negotiate the highest possible price for its oil, against the background of the impact on the market of the OPEC decisions.

020 MW faxed 11/3

CONFIDENTIAL

2

Prime Minister
I think that Mr. Lawson is a match for Sheikh Yamani!
FERB 11.3.

SOS/R 52/83

NOTE OF THE SECRETARY OF STATE'S TELEPHONE CONVERSATION WITH SHEIKH AHMED AZKI YAMANI, SAUDI MINISTER FOR PETROLEUM ON 10 MARCH 1983

The Secretary of State said that, as he had undertaken on 9 March, he had seen BNOC and had spoken to the Prime Minister. He was now in a position to respond to the requests Sheikh Yamani had made.

The UK was anxious to do whatever it could to be helpful but he did not want to promise what could not be performed nor to allow room for any misunderstandings. The one thing BNOC was able to do was to hold its price of $30.50 for 10 days or so - say, to 21 March. It might even be able to hold the price for a little longer, but at present only the 10 days were certain. However, in the meanwhile, he would talk to BP and to Shell.

When BNOC could wait no longer, it would make the smallest cut possible but that would be determined by the state of the market. It therefore depended on how the market reacted to what Sheikh Yamani and OPEC had to say in announcing their package. The more positive the announcement, the better BNOC's chance of continuing to hold $30.50 or at least of minimising its cut.

Sheikh Yamani said that a delay of 10 days was too short. The least he had been hoping for was until the end of the month. The Secretary of State replied that all BNOC's customers had terminated their contracts and could therefore stop buying oil at once. The oil would then be forced onto the spot market. Even a 10 day delay was therefore difficult but, in response to Sheikh Yamani's plea and King Fahd's message to the Prime Minister (to which she would of course be replying), BNOC had agreed to achieve it.

Sheikh Yamani said that he would have to hope for the best. The main thing was that BNOC's cut should be only 50¢ since the Nigerians would match anything more and the whole agreement would collapse. The Secretary of State answered that it was possible, if market sentiment were sufficiently positive, that BNOC might achieve such a cut, although to do so they might also have to extend their credit terms from 30 to 90 days. Sheikh Yamani objected that this was equivalent to a further price cut to which the Secretary of State responded that the Nigerians made BNOC's task harder still by pricing their Forcados crude at $1 below Bonny Light.

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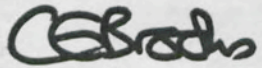
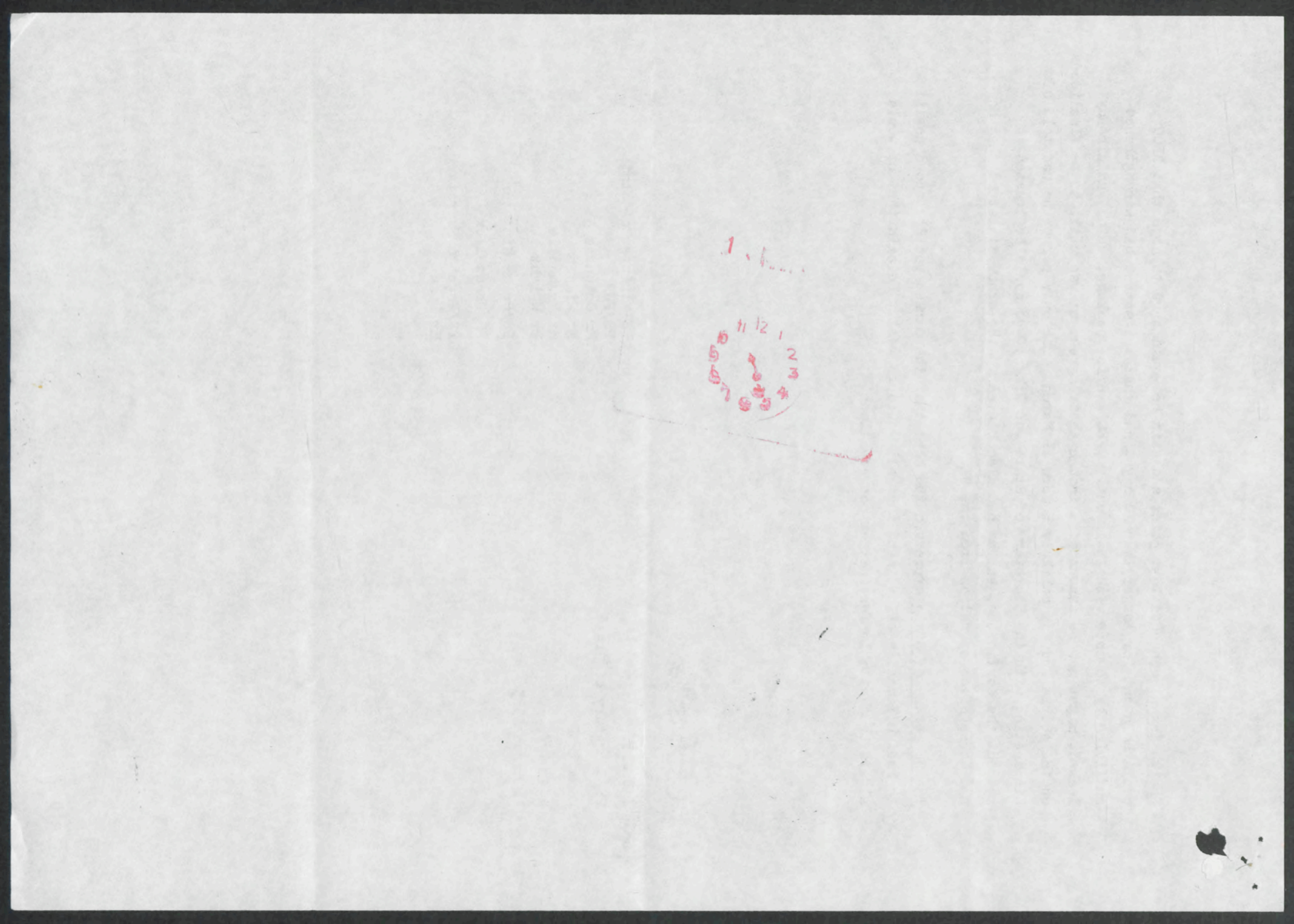
Sheikh Yamani conceded that point and said he would have to hope that BNOC could hold out for longer than 10 days, and that the market had strengthened sufficiently to cope with their cut. OPEC's price package, which had already leaked, might now be announced although their agreement was still to be finalised on the quotas and was unlikely before 11 March. The only person he had told of his meeting with the Secretary of State was Dikko, who could be trusted to respect the confidence, but he had also hinted to the other Ministers that he had hopes of co-operation from the UK.

The Secretary of State expressed the hope that the market would respond positively to Sheikh Yamani's efforts and that all would go well. He said that he would always be available for further conversations.



J D WEST
PS/Secretary of State
Room 1237
Ext 6402
11 March 1983

cc PS/Minister of State
PS/PUS
Mr Guinness
Mr Wiggins
Mr Fremantle
Dr Wright
PS/Prime Minister
PS/Chancellor
PS/Foreign Secretary
Mr Heap



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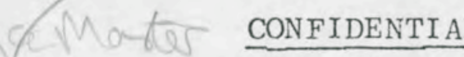

10 DOWNING STREET

From the Principal Private Secretary

10 March 1983

OIL PRICES

The Prime Minister held a meeting at 10 Downing Street at 1615 hours this afternoon to discuss the response which your Secretary of State should make to the proposition put to him by Sheik Yamani and recorded in your minute of 9 March. The Chancellor of the Exchequer, the Foreign and Commonwealth Secretary, Sir Kenneth Couzens, Mr. Middleton, Mr. Evans and Professor Walters were also present.

Your Secretary of State reported on his talk with Sheik Yamani the previous evening. Sheik Yamani had emphasised that, despite considerable pressure, the Nigerians refused to increase their price above $30 per barrel. Sheik Yamani's judgement had been that the success of the OPEC agreement now depended on BNOC's maintaining its current price of $30.50 per barrel until the end of March and then maintaining a price of $30 per barrel. If your Secretary of State could give a favourable response to this proposition, Sheik Yamani said that he could present the OPEC agreement confidently: otherwise he would have to present the OPEC agreement with less conviction. Your Secretary of State said that he had pointed out to Sheik Yamani that neither the British Government nor BNOC could determine the term price of North Sea oil: if the term price was set too high, the oil would have to be sold on the spot market, which would have a far more damaging effect on the OPEC agreement. The British Government could not, as Sheik Yamani had suggested, solve the problem simply by influencing BP and Shell. Having now consulted BNOC, your Secretary of State suggested that the best answer to Sheik Yamani would be to say that he had asked BNOC to hold their current price for as long as possible: BNOC thought that they could hold the current price for at least ten days, and they would then have to assess their future policy in the light of market conditions. The more successful Sheik Yamani was in convincing the market that the OPEC agreement was realistic, the less would be the price adjustment which BNOC would have to make.

In discussion, it was pointed out that the British Government shared with OPEC an interest in avoiding sharp and competitive reductions in the oil price. It therefore matched our political

/and our

and our economic interest to be as helpful to OPEC as possible. But our means of helping in the way suggested by Sheik Yamani were very limited. To restrict our production by leaving royalty oil in the ground would be very expensive and would not have sufficient effect on world supply to enable BNOC to maintain its price. It could be regarded as unreasonable on the part of OPEC to urge BNOC to hold its price when they were envisaging raising OPEC production from its current level of 14 mbd to an average of 17½ mbd over a year as a whole: but to respond to Sheik Yamani by saying that BNOC would only be able to maintain its price as proposed if OPEC was to maintain the current level of production would be to impose a condition which Sheik Yamani could not achieve and which he would regard as a direct rebuff. Other factors which had to be taken into account in considering your Secretary of State's response to Sheik Yamani, and the Prime Minister's reply to the message she had received from King Fahd, were the impending visit of the King of Morocco and the Arab League scheduled for 18 March, and the fact that the industrialised world (including the United States) together with the developing nations which were not oil producers would be hoping for a further reduction in the oil price.

Summing up the discussion, the Prime Minister said that the objective of the United Kingdom should be to achieve a stable oil price. We had therefore both an economic and a political reason for wanting to give as helpful a response to Sheik Yamani as possible. But the United Kingdom could not determine the North Sea oil price and it would not be in our interests to offer to Sheik Yamani what we could not deliver. Your Secretary of State should therefore respond to Sheik Yamani on the lines which he had suggested. She would also need to send a reply to the message from King Fahd and that reply should describe the limitations on the powers of the British Government as strongly and simply as possible: Sir Kenneth Couzens, in consultation with Mr. Middleton and Mr. Evans, should liaise on the draft which should be submitted to No. 10 in the course of tomorrow. The Prime Minister asked your Secretary of State to complete the paper which was being prepared by the Department of Energy in consultation with other departments on the economic and political issues arising from the present oil price situation, so that it could be circulated in time for collective consideration by Ministers before the end of next week if necessary.

I am copying this letter to John Kerr (H.M. Treasury), Brian Fall (Foreign and Commonwealth Office), Sir Kenneth Couzens, Peter Middleton (H.M. Treasury), Richard Evans (Foreign and Commonwealth Office) and Richard Hatfield (Cabinet Office).

Julian West, Esq.,
Department of Energy.

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(PA)

MR. SCHOLAR

cc Mr. Butler
Mr. Coles
Sir Anthony Parsons

OIL PRICE

Sheik Yamani's suggestion that we hold our price to $30.50 now and $30 after the end of March is a Trojan Camel. If we entered into such an undertaking then we would have to adjust our sales and productions so as to support this price. Essentially we would be part of OPEC and roughly speaking in the same parlous state as Nigeria was some two months ago. We would be able to sell very little of our oil.

The economic power of OPEC has been destroyed by its own delusions of perpetual power. Now it is only a political veil loosely rigged to protect reputations and to promote narrow political interests. Even if we wanted to do a deal with them, there is no viable body to enforce it. The dramatic reductions in output required by OPEC to prop up oil prices at about $30 a barrel, are so costly to the participants that there is just no hope of enforcing it.

To please Sheik Yamani, however, we might enter into an undertaking where we are willing to hold our oil price at $30.50/$30 provided the OPEC production quotas are consistent with that price - that is to say little more than the present aggregate level of output of 14mbd and that there is an effective enforcement of this quota by some suitable system, such as fines, etc. This offer could be made in good faith knowing very well that OPEC could never deliver the conditions. But it may provide a face-saver for Yamani.

Another device would be the classic form of chiselling in cartels, deferred rebates. Yet another device is the "loyalty rebate": thus customers who bought oil at £30.50 in March would be enabled to buy a similar quantity of oil at, say, $27 or $28 in April. I do not know whether any of these transparent devices will be a sufficient veil for the reality so as to satisfy Sheik Yamani's objectives.

AW

ALAN WALTERS
10 March 1983

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SOS/R 50/83

Note of the Secretary of State's meeting with Sheikh Ahmed Zaki Yamani, Saudi Minister of Petroleum on 9 March 1983

Also present: Mr West

Sheikh Yamani began by regretting that the Secretary of State had not been sharing the OPEC Ministers' headaches. The Secretary of State replied that the UK had been trying to help. BNOC had come under great pressure to reduce its prices immediately after the failure of the OPEC meeting in Geneva, but had not done so for some time in order to allow OPEC to redeem the situation. When it had lower prices, it had made the minimum cut - $ 3-although its customers had been asking for much more. The Nigerians had immediately under-cut this price but BNOC had not made a further reduction, in spite of great pressure.

Sheikh Yamani said that he knew how the Secretary of State felt. However, the UK shared in OPEC's problem which could become a disaster. All possible pressure had been put on the Nigerians: King Fahd had spoken to President Shagari more than once and Dikko had been recalled to Lagos for consultation; on his return, his position had been more entrenched than before. The Nigerians had a political problem in that one of the issues in their forthcoming election was whether or not they should stay in OPEC. OPEC could not afford to lose them, and nor could the UK.

However, there was no point in keeping them in OPEC unless they could be prevented from lowering their prices. All the other OPEC members had told them that they had over-reacted to BNOC's $ 3 cut,

but everyone knew that in the past BNOC had taken their markets. They would not now admit that there was any differential between their crudes and BNOC's. The Secretary of State interjected that Sheikh Yamani knew that there was some differential and Sheikh Yamani agreed as concerns the US.

He went on to say that OPEC was hoping to settle on a marker of $ 29 with Algeria and Libya at $ 30.50 (to which they had agreed), and Nigeria at $ 30. It was also hoped that the market would allow all these prices to be increased by two instalments of 50¢ each, at which level they would be frozen for two years. However, OPEC's fear was that the UK reaction would be an immediate price reduction which the Nigerians would immediately follow. In that case, the Gulf States would have no choice but to cut the marker to $ 25 - 27 and wait for the market to react.

He said that Sheikh Ali Khalifa had told him that North Sea production in 1983 would be the same as in 1982, and he appreciated that. However, he hoped to make some highly confidential arrangements with the Secretary of State - and would rely on the Secretary of State's word - to keep the Nigerians in line during the transitional period immediately ahead. This was his Government's wish and King Fahd had sent a message to that effect to the Prime Minister. He was certain that demand for oil would shortly start to grow, and that the companies would respect an OPEC agreement which OPEC was determined to defend, and so reverse their destocking once that decision was reached. Therefore, the quota would be 17.5 mbpd on average for the year as a whole. It was only the Iranians who

could not be guaranteed to respect their part in this, but their capacity was limited and they would do as much as they could. Even the Libyans would behave and not resume flooding the market with cheap oil.

The Secretary of State replied that in his judgement 17.5 mbpd would reduce rather than increase confidence in the market . Things might be different if OPEC made it clear that their output would be lower up to the Autumn. BNOC would certainly try to secure the highest price it could get for its oil, but it did have to follow the market as it was at the time. The last thing he wanted was a price war and, if OPEC were to reach agreement in the next few days, he hoped that BNOC could hold its present price in the meanwhile. Thereafter, its price would depend on two inter-related factors: the first was market sentiment and the second was the Nigerian price. He thought that BNOC could perhaps live with a smaller differential than in the past but the plain fact was that there had to be some differential. Sheikh Yamani asked whether this was so even in Europe and the Secretary of State replied in the affirmative, although he said that it could be smaller than in the US. He thought that the differential could perhaps be compressed to $ 1 or even 50¢, if the market had confidence in OPEC's agreement, but could not guarantee that since he was in no position to do so. In his view, it was just possible that BNOC could fit in with Sheikh Yamani's package at $ 29.50.

Sheikh Yamani said that such a response would provoke a price war because the Nigerians would react to it. What he was asking for was a repeat of the delay, with a promise of retrospection, that BNOC had exercised after Geneva. They should exercise their famous British

patience until early or mid-April and then cut by only 50¢. The market would not respond positively to the OPEC agreement immediately but it would respond if only the UK gave it a chance. He would never ask the Secretary of State to do anything impossible or harmful but he was asking for this because he really did need the Secretary of State's help.

The Secretary of State replied that BNOC had been helpful even though it had been very difficult for them and their largest customer had walked away. Sheikh Yamani understood the UK's North Sea regime and what did he suggest BNOC should do with its oil if it could not find customers at $ 30.50? If that oil went on to the spot market the consequences for OPEC would be worst of all. Sheikh Yamani said that there were a million things the UK could do - for example, whisper in the ears of the most difficult companies such as Shell. In any case, this situation would last only for a month or so and, to avoid a price collapse, the UK could afford to lose a few thousand barrels a day for that time. Saudi Arabia was making much larger sacrifices. The Secretary of State said that of course he talked to the British oil companies but that they were free agents. It was the Nigerians who were responsible for the danger of a price collapse. The UK did not wish to make difficulties but it really was the case that he did not control North Sea prices and output. BNOC could delay for a week or so, but no longer or it would lose all its term customers and then be unable to recover them. Sheikh Yamani said that, in the oil business, that could not happen overnight.

He said that he hoped that final details of the OPEC package would be worked out on 10 March and an announcement made that day. He would be carrying the main burden of explaining it to the press.

He did not propose to fight a losing battle so his attitude would depend on the Secretary of State's response to his request. If it were positive, he would convince the market that the agreement would hold. However, if he thought that the UK, followed by the Nigerians, would start a price war his presentation would be weaker and the result would be a deep cut by the Gulf States. A great deal therefore depended on the Secretary of State's response.

The Secretary of State said that it was important that there should be no misunderstanding. He would be as helpful as possible, as he had been all along but he was notoptimistic that BNOC could do what was being asked of them. It was not a question of their taking an initiative, but of how the market would react to OPEC's package. He would consult BNOC on 10 March and let Sheikh Yamani know the outcome. He would also keep this meeting entirely confidential. He understood the burden that Sheikh Yamani had to carry but Sheikh Yamani understood that the UK had a free market system (and was clear that it was in her interest to keep it) and that there should be a differential between Nigerian and North Sea crude. Sheikh Yamani said that he also knew North Sea crude to be an indigenous European crude which other European countries would dearly like to buy on long term contracts. He hoped to see a change in the UK's free market system. He sincerely hoped to have the Secretary of State's backing.

The Secretary of State said that he was always happy to meet Sheikh Yamani and that he hoped to see him in Saudi Arabia. However, there was a difficulty at present. Sheikh Yamani replied that the difficulty was temporary and that the Secretary of State should come in April. He looked forward to hearing from him on 10 March. The

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Secretary of State said that he and BNOC would do their best to be helpful but the market realities were what they were.

J D West

J D WEST
PS/Secretary of State
Room 1237, Ext 6402

9 March 1983

cc PS/MOS
PS/PUS
Mr Guinness
Mr Wiggins
Mr Fremantle
Dr Wright

PS/Foreign Secretary
Mr Heap

PS/Chancellor

PS/Prime Minister

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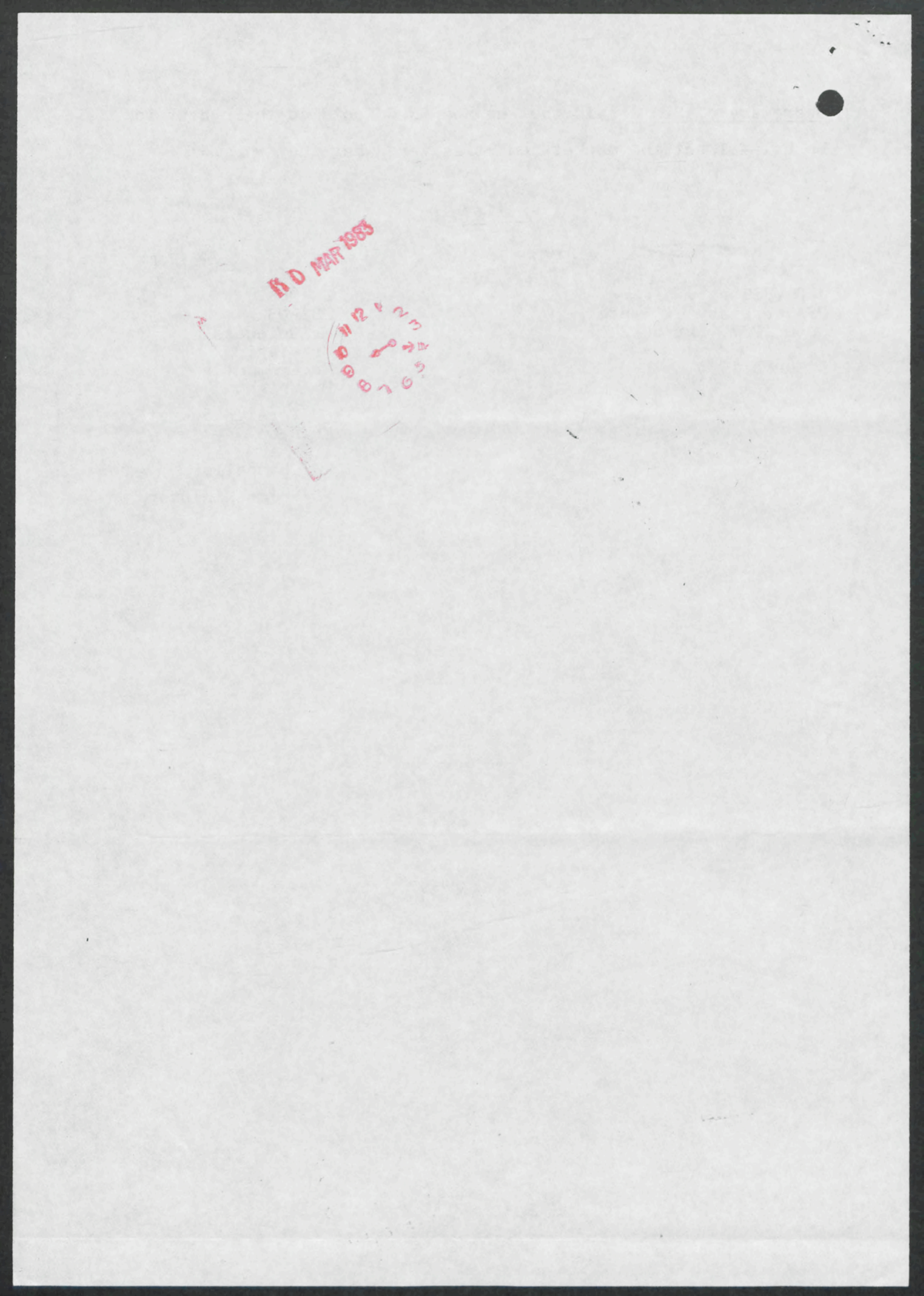
MAR 1983

PRIME MINISTER

cc: Mr. Coles
Mr. Scholar
Mr. Walters

OIL PRICE

I had a telephone report this evening from Mr. Lawson's office about Sheik Yamani's visit to Mr. Lawson this evening.

Sheik Yamani came with a proposition, which he was pleading with Mr. Lawson to accept. He said that a fragile deal was almost within OPEC's grasp, which depended on British co-operation. The agreement was that there would be an OPEC marker price of $29 per barrel; Nigeria would keep to $30 a barrel and Libya/Algeria to $30.50. The OPEC production quota would be an average of 17½m barrels per day (compared with 14mbd now).

What Sheik Yamani wanted us to do was to promise to hold our price at its present level of $30.50 until the beginning of April and then reduce it by 50 cents to $30. He wanted an answer tomorrow. If we said that we would do this, he was confident that the OPEC deal would be struck and would hold. But if we said that we could not hold our price, the Nigerians would match any further reduction we made, OPEC would undercut it and prices would come spiralling down.

The problem is that, with our price above both the Nigerian price and the OPEC marker prices, our oil will not sell. Mr. Lawson concludes therefore that we cannot give Sheik Yamani an undertaking in the form which he seeks.

Mr. Lawson asks your permission to miss E Committee tomorrow morning, and during that time to have discussions with BNOC. He would then like a meeting with you, the Chancellor and the Foreign Secretary in the afternoon to discuss what answer to give to Sheik Yamani; and what answer you might send to the message which King Fahd has addressed to you today (telegram attached). The Department of Energy will circulate a piece of paper tomorrow, but will not be able to do so until Mr. Lawson has seen BNOC, i.e. until the afternoon.

/Do

Yes

Do you agree that we should arrange for you to discuss this problem with the Chancellor, the Foreign Secretary and Mr. Lawson at 4 p.m. tomorrow afternoon? You have an unoccupied hour then before you are due to leave for your regional tour.

F.E.R.B.

9 March, 1983

OIL : ADVANCE COPIES (33)

PS
PS/MR HURD
PS/MR RIFKIND
PS/PUS
MR EVANS
MR WRIGHT
MR ADAMS
MR THOMAS
MR EGERTON
HD/EnSSD
HD/WAD
HD/ERD
HD/ESID
HD/MED
HD/SEAD
HD/NENAD
RESIDENT CLERK

PS No. 10 DOWNING ST.

* MR PRIDDLE
** MR MORPHET
MR WIGGINS
DR J WRIGHT
MR FREEMANTLE
MISS PENNY BOYS
MS CAMERON
PS/ S of S for ENERGY
) DEPT OF ENERGY THAMES HSE SOUTH

MR JF SLATER
MR R LAVELLES
MR N WICKS
) HM TREASURY

MR R MARTIN RM 115
MISS LACKEY WEG
MR D FORD OT5
) DOT 1 Victoria St.

MR GRAHAM HARRISON) ODA

[* until 14 Mar 83
** from 14 Mar 83]

SENT 09 MAR 1983

GR380
CONFIDENTIAL
DESKBY 091530Z
FM JEDDAH 091405Z MAR 83
TO IMMEDIATE FCO
TELNO 131 OF 9TH MARCH
INFO IMMEDIATE WASHINGTON, PRIORITY BAGHDAD, KUWAIT, ABU DHABI, DUBAI, CARACAS, DOHA, TEHRAN, MEXICO CITY, JAKARTA, TEHRAN(1 LAGOS, TRIPOLI, ALGIERS.

IMMEDIATE

ADVANCE COPY

OIL PRICES

1. I HAVE JUST HAD FROM THE HEAD OF ROYAL PROTOCOL BY TELEPHONE A MESSAGE FROM KING FAHD TO MRS THATCHER. THERE IS NO/NO TEXT AND OF COURSE THE HEAD OF PROTOCOL IS NOT AN OIL EXPERT: HE WAS SIMPLY PARAPHRASING AN INSTRUCTION FROM THE KING WHICH I DO NOT SUPPOSE WAS VERY PRECISE IN THE FIRST PLACE.

2. AHMED ABDUL WAHHAB SAID THE KING WAS MOST ANXIOUS TO STRESS TO THE PRIME MINISTER THAT THE BREAK-UP OF OPEC WOULD DO GRAVE DAMAGE TO THE WHOLE WORLD. IT WOULD RESULT IN A PRICE WAR WHICH WOULD BE TO EVERYONE'S DETRIMENT, INCLUDING BRITAIN'S.

3. I ASKED WHAT SPECIFICALLY HMG WERE BEING ASKED TO DO. AHMED SAID THAT OPEC MINISTERS MEETING IN LONDON WERE TRYING TO REACH AN AGREEMENT ON PRICES. THE KING UNDERSTOOD THAT AT THIS MOMENT BRITISH MINISTERS WERE ALSO CONSIDERING NORTH SEA OIL PRICES. ANY LOWERING OF THOSE PRICES WOULD PREVENT OR UNDERMINE AN OPEC AGREEMENT. I EXPLAINED AS BEST I COULD, COLD ON THE TELEPHONE IN ARABIC TO A COMPLETE LAYMAN, THAT, AS YAMANI FOR EXAMPLE FULLY UNDERSTOOD. HMG DID NOT CONTROL OIL PRICES AS SAUDI ARABIA DID HERS. AHMAD SAID HE UNDERSTOOD THAT SEMI COLON BUT THE KING WAS URGING THAT THE PRIME MINISTER IN ANY ADVICE, GUIDANCE OR ENCOURAGEMENT WHICH SHE ISSUED TO THE BRITISH ENERGY INSTITUTIONS SHOULD BEAR IN MIND HIS EARNEST VIEW THAT A BREAK-UP OF OPEC AND A OIL PRICE WAR MUST BE AVOIDED IN EVERYONE'S INTEREST.

4. THE IMPLICATION OF THIS MESSAGE IS THAT THE KING, PRESUMABLY THROUGH YAMANI, HAS NEWS OF SOME DEVELOPMENTS IN LONDON OF WHICH I HAVE NOT HEARD. THIS IS THE FIRST TIME IN THE PRESENT CRISIS THAT THE SAUDIS HAVE APPROACHED US DIRECT ABOUT OIL (THOUGH WE KNOW THAT YAMANI HAS HAD SUCH AN APPROACH IN MIND FOR SOME TIME AND THERE WAS A SLIGHT HINT FROM AHMED THAT YAMANI MIGHT ALREADY HAVE HAD A MEETING WITH MR LAWSON). A SECOND CAUSE OF FRICTION WITH FAHD, COMING ON TOP OF THE EXISTING PROBLEM OF THE PLO, COULD BE VERY DAMAGING TO OUR INTERESTS HERE. I CAN ONLY RECOMMEND THAT IF WE CANNOT SATISFY HIM ON THE SUBSTANCE OF HIS REQUEST, THE MANNER OF OUR RESPONSE SHOULD

DEMONSTRATE THAT HIS MESSAGE HAS BEEN CONSIDERED WITH THE UTMOST SERIOUSNESS AND SYMPATHY: I.E. A PERSONAL MESSAGE FROM THE PRIME MINISTER WITH A CLEAR AND NON-TECHNICAL EXPLANATION OF OUR VIEWS AND THE LIMITATIONS ON OUR POWER.

CRAIG

NNNN

CONFIDENTIAL

Sir A. Parsons (4)

cc Mr. Walters

MR. COLES

Prime Minister

OIL

I see from Paris Tel No 175 that the French are playing around again with the idea of a consumer/producer dialogue. I have no reason for believing that anyone in Whitehall would be attracted by such an idea. But it is worth keeping in mind the appalling trouble which the French have created in the past by indulging in such activities "for political reasons".

To start with, it was the French who brought four Arab Foreign Ministers to the Copenhagen Summit in December 1973 at the time of the one crisis arising out of the Yom Kippur war. This move led to the Euro-Arab dialogue which has been a thorn in our flesh ever since. The French then initiated the CIEC meeting in Paris in 1974 as a kind of consumer/producer dialogue. It was an embarrassing failure which led directly to a Special Session of the General Assembly of the United Nations. This event gave a stimulus to the North/South dialogue and led eventually to the mess we have been in over the past three years or so over Global Negotiations. Meanwhile, French opposition took a lot of the steam out of the IEA, Kissinger's idea put forward in 1974.

I am deeply suspicious of dialogues of the kind which the French seem to like. History shows that they are only attractive to the weaker side. The Shah of Iran was the first to favour a dialogue in 1973. However, in 1974 when OPEC was riding high after the major oil price rise of December 1973, our tentative probing of OPEC about a dialogue fell on deaf ears. In the summer of 1979, I was briefed to sound the Saudis and other Gulf States about the possibility of a dialogue in the wake of another major oil price rise following the Iranian Revolution. The Saudis were implacably opposed to any such exercise. I cannot see any reason why we should now be flexible just because OPEC themselves are in trouble. What we shall have to watch is that the French do not sell the pass and drag other Western countries into another embarrassing and unproductive exercise with the OPEC producers. This may come up at the forthcoming European Council.

A.D. PARSONS
8 March 1983

CONFIDENTIAL

GRS 394
CONFIDENTIAL
FM PARIS 041545Z MAR 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 175 OF 04 MARCH 1983
AND ROUTINE JEDDA, TRIPOLI, LAGOS, MEXICO CITY, CARACAS, JAKARTA, TEHRAN, WASHINGTON, UKREP BRUSSELS, KUWAIT, BAGHDAD, ABU DHABI, MUSCAT, DOHA, OSLO
INFO SSVING UKDEL OECD , ATHENS,BONN, BRUSSELS, COPENHAGEN, DUBLIN THE HAGUE. LUXEMBOURG, ROME.

YOUR TELNO 99 TO JEDDA: MEETING OF OIL MINISTERS IN LONDON

1. THE IDEA OF ESTABLISHING A NEW FORM OF CONSUMER-PRODUCER DIALOGUE HAS BEEN IN FRENCH MINDS FOR SOME TIME. EVER SINCE THEY REFUSED TO JOIN THE IEA, THE FRENCH HAVE SEEN THEMSELVES IN THE ROLE OF BRIDGE-BUILDERS BETWEEN CONSUMERS AND PRODUCERS OF OIL.

2. WE SOUGHT COMMENT FROM THE QUAI AND THE MINISTRY OF INDUSTRY ON THE SUGGESTION THAT FRANCE WAS PLAYING A ROLE IN SEEKING THE ESTABLISHMENT OF A NEW DIALOGUE. THE QUAI WOULD ONLY CONFIRM THAT THE IDEA HAD SOME APPEAL FOR THE GOVERNMENT. DESPITE THE ADVANTAGES OF A LOWER OIL PRICE FOR THE EXTERNAL TRADE BALANCE, IT WAS NECESSARY TO AVOID THE COST OF OIL PRODUCTS TO THE FRENCH CONSUMER FALLING TOO FAR. BUT ANY ATTEMPT TO STABILISE THE PRICE OF OIL PRODUCTS BY FISCAL MEANS WOULD BE SEEN BY OIL PRODUCERS AS A CONFISCATION OF THE ECONOMIC RENT OF THEIR OIL RESOURCES. HENCE ? THE NEED FOR A DIALOGUE. ?

3. THE MINISTRY OF INDUSTRY WERE MORE FORTHCOMING. THE CHEF DE SERVICE RESPONSIBLE FOR INTERNATIONAL QUESTIONS SAID THAT CALDERON BERTI HAD RAISED THE IDEA WITH HERVE AND CHEYSSON ON 2 MARCH. THE VENEZUELAN MINISTER HAD APPEARED TO BE KEEN ON THE IDEA OF A DIALOGUE HIMSELF (C.F. PARAGRAPH 2 OF MY TEL 161), HAD REGRETTED THAT PREVIOUS ATTEMPTS TO ESTABLISH A DIALOGUE HAD BEEN STILLBORN, AND WAS NOW WONDERING WHETHER SOME KIND OF ARRANGEMENT COULD BE ESTABLISHED BETWEEN OPEC AND THE OECD. AT OFFICIAL LEVEL, ACCORDING TO THE MINISTRY OF INDUSTRY, THE FRENCH GOVERNMENT TAKES A SCEPTICAL VIEW OF THE POSSIBILITIES FOR ESTABLISHING A NEW DIALOGUE OF THE KIND ENVISAGED BY CALDERON BERTI. FOR POLITICAL REASONS, HOWEVER, BOTH HERVE AND CHEYSSON /HAD

HAD SHOWN A POSITIVE INTEREST IN HIS IDEAS. AWARE OF THE PRACTICAL DIFFICULTIES IN TALKING TO OPEC IN ITS PRESENT FRAGMENTED STATE, CHEYSSON HAD SUGGESTED THE CONSTITUTION OF A SMALL GROUP OF WISE MEN AS A POSSIBLE WAY FORWARD, WITH THE STIPULATION THAT OPEC MEMBERS SHOULD FIRST AGREE AMONG THEMSELVES THAT THIS WAS WHAT THEY WANTED. CALDERON BERTI HAD APPARENTLY SHOWN SOME INTEREST IN CHEYSSON'S IDEAS, BUT THE DISCUSSION HAD NOT PROGRESSED BEYOND THE LEVEL OF GENERALITIES. THERE HAD NOT, FOR EXAMPLE, BEEN ANY AGREEMENT ON WHAT THE WISE MEN SHOULD DISCUSS.

FCO PLEASE PASS ALL SAVINGS EXCEPT OECD.

FRETWELL

[REPEATED AS REQUESTED]

[OIL]

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PS/PRIME MINISTER

NO.10. DOWNING STREET.

GRS 763
CONFIDENTIAL
FM FCO 041815Z MARCH 83
TO IMMEDIATE JEDDA
TELEGRAM NUMBER 102 OF 4 MARCH
AND TO IMMEDIATE RIYADH, OSLO, KUWAIT, DOHA, ABU DHABI, DUBAI, MUSCAT, JAKARTA, LAGOS, BIS TEHRAN, CARACAS, BAGHDAD, TRIPOLI, ALGIERS, QUITO, MEXICO CITY, BAHRAIN, WASHINGTON
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THE OIL SITUATION

1. POSTS MAY FIND IT HELPFUL TO HAVE THE FOLLOWING ROUND-UP OF CURRENT DEVELOPMENTS.

MEETING OF OIL MINISTERS IN LONDON

2. THE MEETING OF THE 8 OPEC OIL MINISTERS WHO WE BELIEVE TO BE IN LONDON HAS BEEN CONTINUING TODAY, 4 MARCH. OUR MAIN SOURCE OF INFORMATION SO FAR COMES FROM WHAT OTAIBA OF THE UAE SAID WHEN HE CALLED ON MR LAWSON LATE ON 3 MARCH. HE SAID THAT THEY WERE TRYING TO REACH AGREEMENT ON THE BASIS OF AN OPEC PRICE OF THIRTY DOLLARS PER BARREL, AND A PRODUCTION CEILING OF 17.5 MBD, WITH A NIGERIAN PRICE OF THIRTY-ONE DOLLARS AND FIFTY CENTS PER BARREL. THE MAIN OBSTACLE TO AGREEMENT HAD BEEN THE NIGERIAN REFUSAL TO MOVE THEIR PRICES UPWARDS UNLESS NORTH SEA PRICES WERE TO MOVE IN PARALLEL, AND INDEED THERE HAD BEEN A THREAT FROM NIGERIA TO LEAVE OPEC. GULF STATES, ON THE OTHER HAND, HAD APPARENTLY THREATENED A PRICE WAR IF NO AGREEMENT ON SUCH A BASIS WERE REACHED BY THE END OF THE MEETING IN LONDON.

3. IT SEEMS LIKELY THAT A FORMAL MEETING OF OPEC IS BEING PROVISIONALLY PLANNED IN SWITZERLAND OVER THE WEEKEND OR EARLY NEXT WEEK, BUT IT ALSO SEEMS LIKELY THAT THIS WILL NOT BE HELD UNLESS PRIOR AGREEMENT IS REACHED IN LONDON. IT SEEMS THAT SOME OF THE OIL MINISTERS NOT HERE AT THE START OF THE DISCUSSIONS ARE NOW ALSO COMING HERE.

4. OTAIBA ASKED MR LAWSON IF BNOC COULD HOLD ITS PRESENT

PRICE ON THE BASIS OF AN OPEC PRODUCTION CEILING OF 17.5 MBD AND AN OPEC PRICE OF THIRTY DOLLARS PER BARREL, TO WHICH MR LAWSON SAID THAT HE DOUBTED IT BUT WOULD CHECK WITH BNOC, EMPHASISING THAT THIS WAS A MATTER FOR BNOC AND NOT THE GOVERNMENT.

5. THIS ACCOUNT OF OTAIBA'S MEETING WITH MR LAWSON IS STRICTLY FOR BACKGROUND INFORMATION ONLY. THE DEPARTMENT OF ENERGY HAVE CONFIRMED THAT THE MEETING TOOK PLACE, BUT HAVE NOT RELEASED DETAILS.

PRODUCTION CUTS

6. AN IMPORTANT WRITTEN ANSWER WAS GIVEN BY MR HAMISH GRAY ON 3 MARCH IN RESPONSE TO TWO PQS ASKING IF THE SECRETARY OF STATE FOR ENERGY WOULD CUT NORTH SEA PRODUCTION. MR GRAY'S REPLY READS:

QUOTE AS I MADE CLEAR IN MY REPLY TO MY HON FRIEND THE MEMBER FOR HASTINGS (MR WARREN) (VOL 25, C.6) I SHALL NOT IMPOSE PRODUCTION CUTS AT LEAST UNTIL THE END OF 1984. UNQUOTE.

US CONCERNS ABOUT RUMOURS OF UK PRODUCTION CUTS AND LINKS WITH OPEC

7. US EMBASSY OFFICIALS CALLED AT THE DEPARTMENT OF ENERGY ON 4 MARCH SAYING THAT THEY HAD BEEN INSTRUCTED TO MAKE REPRESENTATIONS AT THE HIGHEST LEVEL ABOUT PRESS REPORTS SUGGESTING THAT HMG MAY BE CONSIDERING CONTROLS OVER PRODUCTION, AND THAT THERE MIGHT BE SOME QUESTION OF THE UK COORDINATING ITS PRICES WITH OPEC. THEY SAID THAT WASHINGTON WOULD BE VERY CONCERNED IF ANYTHING OTHER THAN MARKET FORCES WERE THE CONTROLLING FACTOR IN OUR PRICING AND PRODUCTION POLICIES, AND SOUGHT CONFIRMATION THAT WE SHARED THE US VIEW THAT OUR OWN AND OTHER ECOMIES WOULD BEFIT FROM LOWER OIL PRICES.

8. IN RESPONSE, THEY WERE TOLD BY GUINNESS (DUS) THAT SO FAR AS GOVERNMENT CONTROLS ON PRODUCTION WERE CONCERD, THE ANSWER LAY IN MR GRAY'S RESPOE TO THE PQS OF 3 MARCH (PARA 6 ABOVE): THAT NO PROPOSAL TO IMPOSE PRODUCTION CUTS IS BEING CONSIDERED BY THE GOVERNMENT, ALTHOUGH OF COURSE THE EFFECT OF THE GOVERNMENT'S FISCAL DECISIONS COULD LEAD TO A FLAT PRODUCTION PROFILE. ON PRICES, GUINSS SAID THAT THE POSITION WAS CLEAR - THAT OUR POLICY WAS TO FOLLOW THE MARKET . IF AND

WHEN OPEC PRODUCES A NEW AGREED PRICE, AND IF PRICES HELD AT THAT LEVEL, THEN IT WOULD BE FOR BNOC TO DECIDE, IN THE LIGHT OF THOSE NEW LEVELS, ON WHAT THEIR CORRECT PRICE SHOULD BE. HE SAID THAT IT WAS TRUE THAT INDIVIDUAL COUNTRIES HAD BEEN TO TALK TO US, BUT THAT WE HAD TOLD THEM WHAT WE WERE TELLING THE AMERICANS, AND WHAT FOR THAT MATTER WE WERE SAYING PUBLICLY, NAMELY THAT OUR PRICING POLICIY WAS TO FOLLOW THE MARKET, AND THAT WE WERE NOT CUTTING PRODUCTION.

CALL BY MEXICANS

9. THE MEXICAN DEPUTY MINISTER OF ENERGY ALSO CALLED ON OFFICIALS AT THE DEPARTMENT OF ENERGY ON 4 MARCH. IT APPEARS THAT HE IS IN LONDON TO FOLLOW EVENTS ARISING FROM THE MEETING OF THE OPEC OIL MINISTERS, BUT HAD LITTLE NEW TO SAY AND WAS GIVEN THE STANDARD ACCOUNT OF UK POSITIONS.

PS

10. WE HAVE DENIED ON THE RECORD PRESS SUGGESTIONS THAT AN FCO OBSERVER HAS BEEN PRESENT AT THE MEETING OF OPEC OIL MINISTERS.

PYM

[OIL]

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DESKBY 040800Z LAGOS
DESKBY 041000Z ALGIERS
FM FCO 031830Z MAR 83
TO IMMEDIATE JEDDA
TELEGRAM NUMBER 99 OF 3 MARCH
AND TO OSLO, KUWAIT, DOHA, ABU DHABI, DUBAI, MUSCAT, JAKARTA, LAGOS, BIS TEHRAN, CARACAS, BAGHDAD, TRIPOLI, ALGIERS, QUITO, MEXICO CITY, BAHRAIN, RIYADH, PARIS, UKDEL OECD, WASHINGTON, UKREP BRUSSELS,
INFO PRIORITY BRUSSELS, BONN, ROME, LUXEMBOURG, ATHENS, OTTAWA, CAIRO, DUBLIN, COPENHAGEN, THE HAGUE, TOKYO.

FCO TELNO 95 TO JEDDA (NOT TO ALL): MEETING OF OIL MINISTERS IN LONDON

1. IT IS CLEAR THAT OIL MINISTERS FROM MANY OPEC COUNTRIES, INCLUDING SAUDI ARABIA, LIBYA, NIGERIA, VENEZUELA AND INDONESIA, PLUS OMAN, AE MEETING IN LONDON TODAY, 3 MARCH. ALTHOUGH WE HAVE NO DEFINITE INFORMATION ABOUT THEIR MEETING, WE ASSUME THEY ARE LOOKING FOR ADVANCE AGREEMENT ON THE SCENARIO FOR A FORMAL OPEC MEETING IN GENEVA OR VIENNA IN A FEW DAYS TIME. THE VENEZUELAN MINISTER, CALDERON BERTI, SAW MR LAWSON THIS MORNING, AND THE UAE MINISTER OTAIBA WILL SEE HIM THIS AFTERNOON. NO OTHER MINISTERS HAVE SO FAR REQUESTED MEETINGS.
2. CALDERON BERTI TOLD MR LAWSON TODAY THAT OPEC WAS STILL AIMING FOR A THIRTY DOLLAR PER BARREL NEW MARKER PRICE, IF

/THEY

THEY COULD PERSUADE THE NIGERIANS TO MOVE THEIR PRICE UPWARDS. IF THEY COULD NOT SECURE A NIGERIAN MOVE AT THIS NEW LEVEL, THEY MIGHT BE PREPARED TO DROP TO TWENTY-NINE DOLLARS. MR LAWSON SAID THAT HE WISHED TO BE AS HELPFUL AS POSSIBLE, BUT IN THE WAKE OF THE NIGERIAN PRICE MOVE BNOC COULD ONLY HOLD PRICES FOR A SHORT TIME LONGER. THE VENEZUELAN MINISTER ALSO SAID THAT HE AND THE OTHER OIL MINISTERS GREATLY APPRECIATED WHAT BRITAIN HAD DONE TO RESOLVE THEIR CRISIS.

3. IN THE LONGER TERM, HOWEVER, CALDERON BERTI CLAIMED TO BE WORKING WITH MEXICO AND FRANCE FOR A DIALOGUE BETWEEN OPEC AND NON OPEC PRODUCERS AND CONSUMERS TO PLAN A FUTURE STRATEGY FOR THE MARKET. MR LAWSON, WHOLE EXPRESSING APPRECIATION FOR BEING TAKEN INTO CALDERON BERTI'S CONFIDENCE, DID NOT SEE ANY POSSIBILITY FOR LONG TERM AND STRUCTURED MARKET PLANNING OF THAT KIND.

4. ALL THE ABOVE IS OF COURSE FOR BACKGROUND INFORMATION ONLY.

5. THERE IS NO EVIDENCE SO FAR THAT CALDERON BERTI'S LONG TERM PLANS FOR A DIALOGUE HAVE GATHERED SUPPORT, BUT WE SHOULD BE GRATEFUL FOR ANY LIGHT HM EMBASSY PARIS COULD OFFER ON FRENCH INVOLVEMENT IN HIS LONG TERM PLANS FOR THE MARKET.

PYM

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bc Mr Vereker
Mr Ingham

cc Master

10 DOWNING STREET

From the Private Secretary

3 March 1983

Dear Julian,

Oil

The Prime Minister had a brief word with your Secretary of State yesterday afternoon about developments on oil prices.

Your Secretary of State said that he had received a number of visitors from oil producing countries, who had urged UK production cut-backs. He had given these visitors a cordial reception, but had made it clear that the British Government did not seek to intervene in BNOC's pricing policies, which followed market movements. The production programme was governed by existing agreements about depletion; and, in fact, it would be very expensive to exercise our right to leave the royalty oil under the ground for lifting later.

The Prime Minister said she agreed that this was the right stance for the Government. We had no intention of joining forces with the OPEC cartel, and should listen politely to such representations. Your Secretary of State said that it was helpful during these conversations to make the point that there would, in any event, be no increase in oil production next year.

I am sending a copy of this letter to John Holmes (Foreign and Commonwealth Office) and Margaret O'Mara (HM Treasury).

Yours sincerely,

Michael Scholar

Julian West, Esq.,
Department of Energy.

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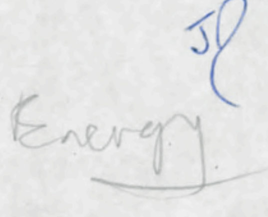

10 DOWNING STREET

From the Private Secretary

SIR ROBERT ARMSTRONG

MEETINGS BETWEEN OPEC AND NON-OPEC PRODUCERS

Thank you for your minute of 24 February.

The Prime Minister does not think it necessary that the group of senior officials should be reconvened to consider the question of meetings between OPEC and non-OPEC producers. She is clear in her own mind that we should not support the formation of what would effectively be an enlarged OPEC.

A. J. COLES

1 March 1983

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary 1 March 1983

OIL PRICES

The Prime Minister has seen your Secretary of State's letter of 25 February to the Foreign and Commonwealth Secretary on this subject.

You may like to know that the Prime Minister has minuted to the effect that we should not support the formation of what would effectively be an enlarged OPEC.

I am copying this letter to the Private Secretaries to the members of OD, and to Sir Robert Armstrong.

A. J. COLES

Julian West, Esq.,
Department of Energy.

10 DOWNING STREET

John

I have passed the this news on orally to Cabinet Office, Energy + the FCO.

TJ

No need. We do not want to form what would effectively be an enlarged OPEC. No need for any meeting.

10 DOWNING STREET

Prime Minister

Meetings between OPEC and non-OPEC producers.

Sir Robert Armstrong suggests a group of senior officials under Cabinet Office chairmanship to consider this subject.

2. Nigel Lawson does not want such a group. He is preparing a paper for OD colleagues (see attached letter).

3. Agree that I should tell Sir Robert that you are content for this to be handled in OD?

A.J.C. 25/2.

CC RJ

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01-211-6402

The Rt Hon Francis Pym MC MP
Secretary of State for Foreign and
Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
London SW1

25th February 1983

Dear Secretary of State

OIL PRICES

Thank you for your minute of 22 February about your discussions in Mexico.

I agree with you that while there are serious objections to a formal dialogue with other oil producers, and particularly with OPEC, bilateral contracts may be useful. As you know, both Hamish Gray and I are already engaged in a number of Confidential bilateral Ministerial meetings in which we can hear about the concerns of other producers and explain our own position. We will continue to be very ready to exchange views in this way.

I am however preparing a paper which we might discuss in OD on the indications for the UK of possible developments in oil prices, and on how we might react to those developments. I hope that such a paper will give us an opportunity to discuss a number of the points raised in your letter.

I am copying this minute to the Prime Minister, to OD colleagues and to Sir Robert Armstrong.

Yours sincerely

pp NIGEL LAWSON
(Approved by the Secretary of State
and signed in his absence)

25 FEB 1983

Ref. A083/0637

MR COLES

You will have seen the Prime Minister's copy of the minute which the Foreign and Commonwealth Secretary sent to the Secretary of State for Energy (FCS/83/38) of 22 February about oil prices following his visit to Mexico.

2. In paragraph 4 of that minute, the Foreign and Commonwealth Secretary suggests that it might be useful to hold a meeting of senior officials to consider our reaction to pressures for meetings between OPEC and non-OPEC producers. The Cabinet this morning were inclined to think that we should not get involved in such meetings; but we still need to consider the tactics of that response.

3. A group of senior officials under Cabinet Office chairmanship was set up to consider possible interruptions of oil supplies and then later to implications of oil price reductions. This subject could now be put to this group. If the Prime Minister agrees, you might like to write on the lines of the draft attached.

RTA

ROBERT ARMSTRONG

24 February 1983

DRAFT LETTER TO B J P FALL ESQ, FCO

The Prime Minister has seen your Secretary of State's minute of 22 February to the Secretary of State for Energy about oil prices.

The Cabinet on 24 February were inclined to the view that it would not be helpful for the United Kingdom to become involved in meetings between OPEC and non-OPEC producers on the future of oil prices. Nonetheless it would still be useful for officials to work out our considered response to such pressures over the coming weeks. A group was set up under Cabinet Office chairmanship which produced earlier reports on the supply and price of oil. ~~She~~ The Prime Minister proposes, if your Secretary of State agrees, to ask Sir Robert Armstrong to arrange for this group to be re-convened for the purpose now proposed.

I am sending copies of this letter to the Private Secretaries to other members of OD, the Private Secretary to the Secretary of State for Energy and Richard Hatfield.

PRIME MINISTER

OIL PRICES

Nigel Lawson's Office telephoned this afternoon to say that he had had a message from the Kuwaiti Oil Minister to the effect that the latter wished to come and see him on Friday morning as representative of the Gulf Cooperation Council and Iraq.

Mr. Lawson is in little doubt that the objective will be to put pressure on us with regard to North Sea oil prices. Mr. Lawson will, of course, take the line that our behaviour in recent weeks has shown that we are concerned for the stability of the oil market but that in the end it is for BNOC to take their decisions in the light of the market.

Mr. Lawson has informed the Foreign and Commonwealth Secretary of this démarche but otherwise does not wish to broadcast it. He will, therefore, not be bringing it up in Cabinet tomorrow.

A.J.C.

23 February 1983

CONFIDENTIAL

Energy

Prime Minister

MLS 17/2

01-211-6402

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

17 February 1983

Dear Chancellor,

OIL PRICES

Further to my letter of 14 February, BNOC has now confirmed to me that it wishes to propose a new price to its customers and suppliers tomorrow morning. This will be $30.50 a barrel for the main North Sea grades, a cut of $3 a barrel. In addition, the offshore-loaded crudes have become increasingly difficult to place over the past year because of changes in freight costs and quality differentials. For these, which amount to some 10% of BNOC's sales, cuts will need to be made of up to $3.50 a barrel.

The proposed new prices can be fully justified in the light of the current world market and are consistent with what seems to be Saudi Arabia's strategy of consolidating a new world pricing system around a price for Arabian light of $30 a barrel. On that basis, they will slightly reduce the competitive advantage of North Sea crudes over those from the Gulf and Nigeria. They thus offer the best prospect of avoiding a round of competitive undercutting.

BNOC thinks there is a fair prospect that with the proposed new prices it will retain its existing term customers and may even regain some of its contracts with Gulf Oil. The oil market is bound to remain unsettled for some time to come; meanwhile this outcome, if achieved, would be very satisfactory.

I am sending a copy of this letter to the Prime Minister.

Yours sincerely,

NIGEL LAWSON
(Approved by the Secretary of State
and signed in his absence)

CONFIDENTIAL

CONFIDENTIAL

J Cc JV

NBPM

MES 8/2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

7 February 1983

Julian West Esq
Private Secretary to the
Secretary of State for Energy
Thames House South
Millbank
LONDON SW1P 4QJ

Dear Julian,

BNOC OIL PRICES

Further to the Chancellor of the Exchequer's letter of 28 January on this subject, you might like to have, for background information, the attached Inland Revenue note on the relationship between BNOC's formal selling price and the tax reference price. The BNOC price can only be the tax reference price for as long as it is the market price. If that linkage is broken, there would be a substantial tax cost on the 50 per cent of UKCS crude not traded on the open market but transferred within oil company groups through non-arms length inter-affiliate deals.

I am sending copies of this letter to Michael Scholar (No 10), Brian Fall (FCO), John Rhodes (Department of Trade) and Richard Hatfield (Cabinet Office).

Yours ever,

J O KERR

CONFIDENTIAL

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BNOC OIL PRICE AND TAX REFERENCE PRICES

1. Where oil (or gas) is sold at arm's length the actual price received is taken into account in North Sea tax calculations. Otherwise - principally, where oil is sold to an affiliate or used for refining within the same group of companies - the value brought into the tax calculation is the price which the oil would have fetched in an arm's length sale. Only about 50% of crude is sold at arm's length; the remaining 50% has to be valued at market value.

2. Until recently the vast bulk of crude sold arm's length has been sold in term deals (ie deals lasting for a period of months where the price is renegotiated periodically - usually quarterly) by BNOC or by other companies at BNOC's selling price. This is because BNOC is the largest supplier of arm's length crude and effectively sets the market. The Inland Revenue has therefore been able to use the BNOC price as the market price for tax valuations, arguing that spot prices were irrelevant because they applied only to marginal quantities.

3. In recent months the volume of spot sales has increased (at times reaching as much as 30% of arm's length sales). Spot prices have generally, but not exclusively, been well below term prices. The Revenue has nevertheless been successful (for past periods) in defending BNOC's term price as the proper analogue for valuation. This could easily be undermined if it could be proved that substantial volumes of arm's length crude were moving at lower prices. This could happen in three ways:

a) If BNOC were unable to sell at its official price and had to sell substantial volumes spot. (The artificiality of the official price would be emphasised by the fact that BNOC was making losses.)

b) If BNOC had to offer discounts on substantial volumes.

c) If other producers than BNOC started to sell significant additional volumes of crude either spot or term at prices below BNOC's official price.

4. It is impossible to tell what volumes, size of discount or period of time would trigger the disconnection of the tax reference price from BNOC's price. Ultimately, it would depend on what an independent appeal body would decide was the market price and when the first company thought the issue worth forcing to appeal. Nor is the size of the effect clear: in assessing what the true market price is for tax purposes the Revenue might have to move to a weighting of the official BNOC price and the discounted or spot price, or could find itself pushed close to the lowest price prevailing in the market.

5. The effect therefore of a relatively small additional amount of crude being sold spot or at a discount, therefore, could trigger a substantial tax loss. The current differential between spot prices and BNOC's term price is about $5 a barrel. If spot sales or discounts led to this price ($28.50) being taken as the tax reference price, this would cost £60m a month in lost royalties and tax compared with a cut in the term price to, say, $31.00 a barrel.

Energy Jan 80 North Sea
Oil Prices

- 8 FEB 1983

CONFIDENTIAL

Energy

ENERGY.

c/c JV

Prime Minister (2)

MCS 31/1

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

31 January 1983

The Rt Hon Nigel Lawson MP
Secretary of State for Energy
Thames House South
Millbank
LONDON SW1

Dear Nigel

BNOC OIL PRICES

As my Office has already told yours, I agree that for the time being we should follow the third option for North Sea oil prices, described in your minute of 28 January. This means that BNOC would make no price change now, but would put its suppliers on notice that, given the uncertainties of the markets, it reserved the right to make a price change, retrospective to 1 February, if necessary.

An important assumption underlying this option is that BNOC will not lose so many customers that it would be forced into distress sales of unplaced participation or royalty oil at a price which would undermine the tax reference price based on the ruling term price. This could well happen if the Corporation tried to pursue the third option for more than a week or so, and perhaps even less. If the ruling term price were replaced by the lower spot price for tax reference purposes, very large amounts of tax revenue would then be lost.

I should therefore be grateful if your Department could continue to keep the Treasury and the Inland Revenue in very close touch with BNOC's negotiations. If it were to appear that the tax reference price was likely to be jeopardised, we would need to reconsider the options very quickly.

Copies of this letter go to the other recipients of yours, and to Sir Robert Armstrong.

GEOFFREY HOWE

CONFIDENTIAL

Energy: North Sea Oil Prices
Jan 80

CONFIDENTIAL

Energy

2 pps

Prime Minister (2)

MCS 31/1

CC JV

FCS/83/15

SECRETARY OF STATE FOR ENERGY

BNOC Oil Prices

with MCS

1. Thank you for copying to me your letter of 28 January to the Chancellor.

2. I agree with the line you propose, namely that BNOC should delay settling a new price until about 15 February, but give their customers an assurance that any price change would be made retrospective to 1 February. I am concerned, as you know, that other oil producers should not be able to blame us for their economic difficulties if we were to lead a world-wide fall in the price of oil, but I think that your proposal strikes the right balance. We will continue to monitor the reactions of OPEC countries very carefully.

3. I am copying this minute to the Prime Minister and Lord Cockfield.

(FRANCIS PYM)

Foreign and Commonwealth Office

31 January 1983

CONFIDENTIAL

Energy: North Sea Oil Prices
Jan '80

31 JAN 1980

CONFIDENTIAL

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

CC JV

From the Secretary of State

Julian West Esq
Private Secretary
to the Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London
SW1P 4QJ

31 January 1983

Dear Julian,

BNOC OIL PRICES

This is to confirm that the Secretary of State agreed with the suggestion in your Secretary of State's 28 January letter that BNOC should follow the third option. He has commented that it is very important that we should not "get in front" of the Saudis in making any price changes. Thus, any retrospective price changes should not be dated earlier than any Saudi price change.

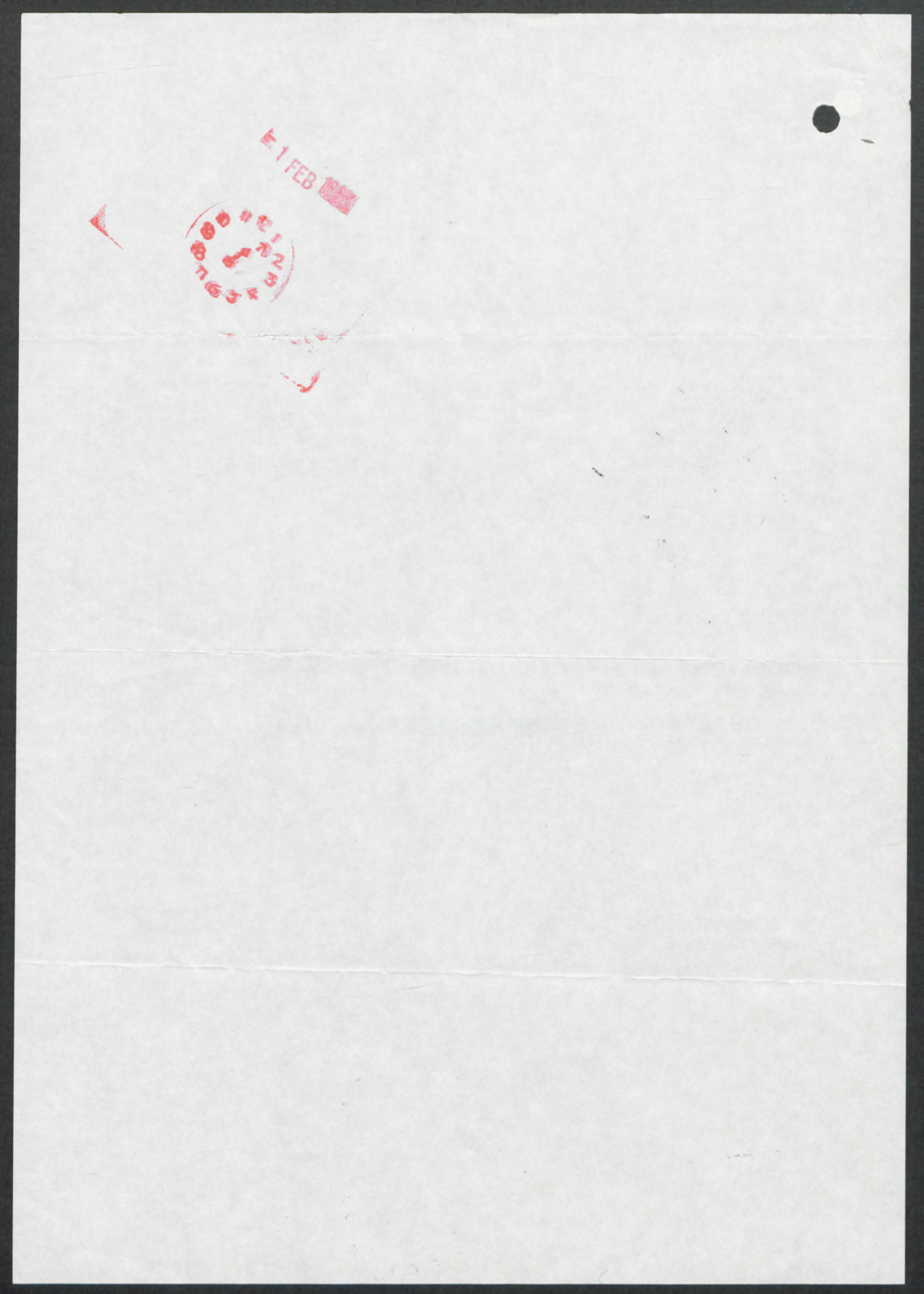
I am copying this letter to Robin Butler (No. 10) John Kerr (Treasury) and Brian Fall (Foreign and Commonwealth Office).

Yours sincerely,

John Rhodes

JOHN RHODES
Private Secretary

CONFIDENTIAL



CONFIDENTIAL

Ziu AH
ccs FCO
D/T
Tsy

10 DOWNING STREET

From the Principal Private Secretary 31 January 1983

Dear Julian,

BNOC OIL PRICES

The Prime Minister saw over the week-end a copy of the Secretary of State for Energy's letter of 28 January to the Chancellor of the Exchequer.

The Prime Minister agrees that the third option in the Secretary of State's letter is better than either taking no action at all or notifying a general price change now; but she has suggested that BNOC should also consider dealing with the problem by giving a private discount to its largest customers.

I am copying this letter to John Kerr (Treasury) Brian Fall (Foreign and Commonwealth Office) and John Rhodes (Department of Trade).

Yours sincerely,

Robin Butler

Julian West Esq.,
Department of Energy.

AH

CONFIDENTIAL

1

Prime Minister

If BNOC are not to lead the market down, the option in para. 7 looks the best course open. Agree?

FERB 28.1.

Yes - but surely they can give a prudent discount off list price to their larger customers?

01-211-6402

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

28 January 1983

Dear Chancellor,

BNOC OIL PRICES

BNOC has to take a decision by midday on Monday, 31 January about the action it is to take on its price for North Sea oil. Five of its customers have now given notice to reopen the negotiations on prices to apply from 1 February, led by the largest single customer (Gulf). Further notifications must be expected. I have of course been in close touch with BNOC and must let them know my view on Monday morning.

2. The difficult background of this decision is well known to you. We are trying first to maintain, both in substance and in appearance, our policy of following the market in determining North Sea oil prices, not leading it. On this occasion we are doing this in a situation in which Saudi Arabia is trying its best to push us out in front. Secondly, it is of crucial importance to us to maintain oil sales and the revenue and taxes which flow from them, on a falling market. Thirdly, we need to avoid precipitating a downward price spiral which, simply because of the scale of adjustment it would render necessary, would be damaging both for our own economy and more widely. There is a difficult balance to be struck here.

3. BNOC has three options. The first would be to take no action at all for the present and resist the demands from its customers to reduce prices, perhaps with a view to looking at the situation again in the second half of February. But BNOC judges that by the beginning of March most of its term contract customers, accounting for about 500,000 barrels a day, would have phased out. The oil which could not be sold on term contracts would then have to be disposed of in the spot market. The present differential is some $5 a barrel, and there is some risk that placing substantial additional volumes on the spot market would itself drag down the whole level of prices.

4. Direct losses to BNOC under this option would, as far as we can see, start at about $600,000 a day in the first half of February, escalating to $2½m a day at the beginning of March. (Because of the tax offset, the net loss to the public sector would be only one quarter of these amounts). However, in present market conditions BNOC could well find it extremely difficult to recover its term customers even with a reduction in prices, so losses reflecting the difference between term and spot prices could continue for many months. There would in addition be serious tax consequences. BNOC's term sales price is the reference price against which the Inland Revenue taxes disposals of North Sea crude which are not on an arms-length basis. If the majority of BNOC sales were at spot instead of term prices, the Inland Revenue would have to value all non-arms-length disposals at spot price, which is likely to be some $3 below a sustainable term price. Altogether, the loss to the Inland Revenue, together with the loss to BNOC would amount to about £100m a month.

5. The second option is the one which BNOC, acting strictly in its own commercial judgement, would prefer. It would be to notify a new term price to both its customers and its suppliers, effective from 1 February and involving a reduction of $2.50 a barrel. It judges that the course would hold all or nearly all its term customers, at least for the time being.

6. This course has attractions in maintaining sales and the flow of revenue on a falling market. But it enables the Saudis and other OPEC members to say that the UK has led the price down. I have little doubt that the Saudis would in fact rapidly follow suit and that any indignation which they or other OPEC members expressed would be simulated. Nevertheless, it could provide an excuse for hostility by those who might be looking for such an excuse. This hostility could be directed against our trade or banking interests. And there remains the risk that our move would precipitate a spiral for which we would then be given a disproportionate share of blame. This option therefore carries some risk in relation to all three objectives in paragraph 2.

7. Under the third option BNOC would make no price change now but would put its suppliers on notice that, given the uncertainties in the markets, it reserved the right to make a price change retrospective to 1 February if necessary. Meanwhile BNOC would ask those of its customers who requested a price review to defer action until the market situation had further clarified itself, and would give them an assurance that any price change would be made retrospective - to all customers - to 1 February. BNOC considers that this course would enable it to delay settling a new price until about 15 February and to retain the majority of its customers. It might well however lose its largest term customer (Gulf) and perhaps one or two others besides. The net cost to the public sector over this period would be of the order of £1½m.

8. BNOC would attempt to keep confidential what was said to suppliers and customers under the third option, but we must expect that reports of the line it was taking would reach the press. These notices would be taken as an indication that BNOC expected to have to reduce its prices within the month. But this action falls short of an actual reduction and could hardly be presented as leading the price down. It could well entail some loss of sales revenue but probably avoids irreparable harm to BNOC's term contract structure. And while we may still be faced with a difficult decision about a price reduction in a fortnight's time, there is a chance that by then at least some OPEC prices would visibly have crumbled further so that the blame for initiating a reduction could not be laid at our door.

9. Unless you dissent, I therefore propose to ask BNOC on Monday to adopt option three. The notifications would issue during Monday afternoon.

10. I am copying this letter to the Prime Minister, Francis Pym and Arthur Cockfield.

Yours sincerely

C Brooks

NIGEL LAWSON

(Approved by the Secretary of State and signed in his absence).

28 JAN 1983

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

Prime Minister

MCS 26/1

CONFIDENTIAL

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

25th January 1983

Dear Geoffrey

PRICE OF UKCS OIL

Even before the OPEC meeting which collapsed in disarray yesterday BNOC had been given formal notification of price renegotiation by Gulf and Shell on 150,000 barrels a day in total. BP has also warned that it will seek a price change from 1 February. The outcome of the Geneva OPEC meeting, coupled with Sheikh Yamani's prediction that North Sea prices would fall by at least $2 - $3 a barrel within the next few days, are almost certain to inspire the rest of BNOC's customers to seek a price reduction.

BNOC is to meet Gulf and Shell this week. Provided that no other customers have made formal requests for a price review BNOC will resist agreeing to any individual price discounts. But if the exposed volume exceeds about 150,000 b/d the Corporation believes it will sooner or later have no choice but to offer an across the board reduction since we cannot afford a situation in which BNOC is left with large quantities of unsold oil on its hands. At this stage no-one can say precisely how big a price cut will be needed to clear the market, but it seems likely to be of the order suggested by Yamani.

I would very much prefer that BNOC made no move unless the Gulf, or indeed others, first reduced their prices, and this has been made clear to the Corporation. But for the reason set out above, BNOC has very little flexibility over timing. I shall do what I can to take some of the pressure off BNOC, at least for a few days, and the Corporation will itself seek to avoid any commitment for as long as possible. But at the end of the day we cannot rely on forcing the Gulf producers to move first. Indeed, the main purpose of Yamani's North Sea prediction was almost certainly to force BNOC to move first, so that he could then blame us for any subsequent Gulf price cut.

The situation is developing quickly. BNOC has undertaken to consult me before making a formal move. It may well come under increasing pressure towards the end of this week, with the risk of its being left with large quantities of UKCS oil unsold. I will keep you informed of developments.

I am copying this letter to the Prime Minister, Francis Pym and Arthur Cockfield.

Yours ever
Nigel

NIGEL LAWSON

26 JAN 1983

4.1 CONFIDENTIAL

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

OIL PRICES IN THE LONG TERM

I attach a study, written by an interdepartmental group of officials under Treasury chairmanship, which examines the longer term prospects for the supply and demand of energy and the possible implications for oil prices.

2. I think this is a useful document, which is suitably modest in its objectives. It acknowledges the immense difficulties involved in making projections, and does not make a forecast, let alone a unique one, for the oil price. Rather, by looking at the likely supply and demand position, it attempts to provide guidance on a broad range of possible oil prices in the long term, stressing the need to allow for the risks and uncertainties involved. This guidance should be helpful to those in the public sector concerned with decisions about policies and projects for which the price of oil is a relevant consideration.

3. Also attached to this minute is a note by the Chairman of the inter-departmental group which summarises the conclusions of the study.

4. The note recommends, and I agree, that the study (like its predecessor, written in 1980) should be made generally available in a low key way. I understand that Nigel Lawson would be content with this. It would be made clear that it is a study by officials, intended as broad guidance for decision-makers in the public sector. It would not be presented as an oil price forecast to which Ministers were necessarily committed.

5. My officials are therefore arranging for a copy of the study to be placed in the House of Commons Library today and for this to be announced in answer to a written PQ.

6. I am copying this minute to the other members of E and to Sir Robert Armstrong.

(G.H.)
23 December 1982

PROSPECTS FOR THE OIL PRICE IN THE LONG TERM

CHAIRMAN'S NOTE

see LHS of file cover.

The attached study sets out an interdepartmental working group's view of the prospect for oil prices to the year 2000 and beyond.

2. Events in the oil markets in the last few years have underlined the difficulty of making exact predictions even for a short time ahead. Nevertheless those analysing policies and appraising projects which involve energy supply and energy use need to make price assumptions. But they should take full account of uncertainty. Hence the study, unlike its predecessors, has not attempted to produce a central planning figure for the oil price. Instead, likely price bands are set out on the basis of a number of assumptions and hypotheses.

3. The rate of economic growth is a key factor in determining the future price of energy. Hence two price bands have been estimated, one relevant to a world of low economic growth and one relevant to a world of higher growth. (The growth assumptions are slightly lower than the ones made two years ago.) In each case the price range takes account of uncertainties about energy conservation as well as about the supply of other forms of primary energy (coal, gas, hydro-electric power, etc.) and of oil production from both OPEC and non-OPEC sources. The group looked at the supply of OPEC oil on the basis of different political and economic assumptions.

4. The price of oil affects both the supply and demand of oil and of other forms of energy. The evidence of the last two years suggests that energy demand is becoming increasingly responsive to price changes. This limits the likelihood of sustained large increases in price. We also allowed - to a greater extent than previously - for the effect of higher oil prices on the supply of other fuels. In extending the work into the next century, we took account of the development of alternative energy sources on a scale sufficiently large to restrain possible further growth in oil prices.

. Oil markets have been particularly susceptible to shocks of one kind or another. In the 1980 study, it was assumed that oil price increases would take the form of discontinuous jumps often induced by shocks and that subsequent real price reductions would be rare. Recent events have shown this to be a defective approach. In a world of lower economic growth, where high energy prices seem to be leading to conservation on a significant scale, some real price reductions are likely to take place from time to time. How far they might go will depend in part on OPEC and the extent to which OPEC members are ready to support prices by restricting output. Our analysis suggests that the interests of the members may be more divergent than in the past. Nonetheless, OPEC's influence is likely to mean that prices in the short term will not wholly reflect the free operation of markets.

6. The early chapters of the study set out the supply and demand for energy on a number of scenarios concerning economic growth, availability of non-OPEC fuel supplies and price and income elasticities of demand for energy. On the basis of this work we discuss OPEC's potential for influencing oil prices. Overall supply and demand are then brought together and feasible price zones set out for the late 1980s/early 1990s, the end of the century and the early 21st century. Final results are shown in the form of two broad price paths - one for each economic growth scenario - in Figure K after page 22.

7. These price bands are in no way forecasts. They indicate longer term trends rather than the actual position at any one point in time. Also they are "surprise free", that is, they do not allow for major disturbances which would have a lasting effect on energy prices such as a large scale nuclear power accident, nor do they allow for major fuel discoveries or new forms of conservation. It is quite likely that oil prices will fluctuate, even in the absence of major shocks of this kind. Moreover, sudden and temporary changes in the supply/demand balance (e.g. arising from disruption to oil supplies in the Middle East) could take the price outside the bands we have indicated, either in particular years, or for a longer period of time. But these more temporary disturbances should not affect the long term trend. For general uses the price bands in Chart K offer a reasonable compromise between the increased confidence that a wider range would

ncompass the outturn and the greater practical usefulness of a narrower range.

8. For this reason, and for others, those using the results of the study in policy analysis or project appraisal should look as carefully at the underlying assumptions as at the final results. They will need to choose the particular numbers relevant to the particular analysis or appraisal in hand. They will also have to choose the range of uncertainty over which they consider it right to test their analysis.

9. The study should be of value outside the Government, particularly in the nationalised fuel industries. The group considers, therefore, that the work (but not this cover note) should be made generally available in the form of a study by officials. The 1980 report was only published in an expurgated form after a delay of 18 months, although the main conclusions were given to the nationalised energy industries and to the Select Committee on Energy. This time we have avoided a central planning figure, so there is even less of a flavour of a Government position.

10. The group looked at the relationship between our projections and those made by other bodies during the last couple of years. Most forecasters are revising down their views about future energy demand and prices, so comparisons need to take account of precisely when studies were carried out. Oil companies, where they have been prepared to publish, generally give price projections covering the lower two-thirds of the price range covered in our recommendations. We discussed our work with Shell, who have also been revising their figures. They told us that although their range for the year 2000 was somewhat below ours, the difference was within the margin of error inherent in this work and that they broadly agreed with our analysis. Academic forecasters, on the other hand, tend to give a price range covering the upper half of our recommendations. Some of the latter include the possibility of the oil price rising even higher, though in most cases these high projections are based on studies which are two or more years old and therefore do not reflect recent evidence on energy conservation. Some experts, such as Professor Odell, think that in the short term oil prices will be weak, but their central guesses on longer term prices are generally within the range we recommend.

11. The study looks a long way ahead. Currently the market is very uncertain and there could well be a break in the nominal oil price within the next few months. We think that the low end of our range for the 1980s - a real oil price of $25, some 25% below present prices - allows for as large a fall as could be expected to persist for more than a few months. In the 1990s economic growth is likely to raise energy demand, leading to at least a recovery of prices and quite probably to real price increases.

I C R BYATT

HM Treasury
Parliament Street
London SW1

15 December 1982

OIL PRICES IN THE LONG TERM

an examination of trends in energy supply and demand and their implications for the price of oil.

A Study by

An interdepartmental Group of Officials

LONDON

DECEMBER 1982

11/3

OIL PRICES IN THE LONG TERM

An examination of trends in energy supply and demand, and their implications for the price of oil

A study by an Interdepartmental Group.

(The following were represented on the Group: Department of Energy, Foreign and Commonwealth Office, HM Treasury, Department of Trade, Central Policy Review Staff, Bank of England).

CONTENTS

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II PREVIOUS WORK

III RECENT DEVELOPMENTS

IV METHODOLOGY

V ENERGY DEMAND

VI ENERGY SUPPLIES

VII ENERGY BALANCES AND PRICE DEVELOPMENTS

VIII CONCLUSIONS

IX APPENDIX: REVIEW OF OTHER RECENT STUDIES

December 1982

I. INTRODUCTION

1. Those concerned with a variety of investment appraisals and energy policy decisions need to take a view about the longer term price of energy, in particular about the likely trends in world oil prices. There is, of course, a great deal of uncertainty about this. World oil prices will be affected not only by uncertain economic factors, such as the rate of economic growth, but also by political choices affecting, for example, the expansion of nuclear power in the West, and depletion policies in important oil producing countries. Oil price forecasts can easily go wrong, and attempts to indicate a single assumption for planning purposes have not proved to be very useful.

2. This study has therefore concentrated on assembling the evidence on energy supply and demand in order to indicate a range of feasible projections for oil prices in the longer term. So it is more in the nature of general guidance for decision makers than specific advice on the price assumptions they should use in their work. Individual decision makers should themselves consider carefully the price assumptions against which proposals should be tested: this study provides a framework for them to do this.

II. PREVIOUS WORK

3. Since the first oil price shock in 1973, there have been several inter-departmental studies of long term oil price prospects. Figure A shows the central projections made in each of these studies, against the background of the actual price path since 1945. A review of these studies shows how the perspective on future oil prices has changed over the period. Perhaps inevitably, some of the projections may have been over-influenced by the current state of the market and the short term outlook. It also needs to be borne in mind that over the years the studies have become more sophisticated, if not more certain about their end-product.

4. <u>The 1974 study</u>, written in the immediate aftermath of the first price shock, now seems very much a product of its times. Predictions of OPEC's imminent demise and the reversal of the previous year's sharp price increases influenced the mood. Addressing itself only to the medium term, the study envisaged a substantial fall in the real oil price by 1985.

5. Subsequent studies looked further ahead, to 2000. Table 1 below compares their central cases:

TABLE 1: PREVIOUS OIL PRICE PROJECTIONS (CENTRAL CASES)

	$ 1980 prices Oil price in 2000	Annual rate of increase to 2000
1975 Study:	27	3½%
1977 Study:	44	4½%
1980 Study:	65	4%

6. The <u>1975 Study</u> concluded that a broad doubling of the real price by 2000 should be the central estimate for planning purposes, though a higher price than this was a little more likely than a lower one. The <u>1977 Study</u> confirmed its predecessor's conclusion that the price in the long term would be significantly higher. Assuming a world growth rate averaging 4 per cent a year, the Study projected a central estimate for the real oil price in 2000, nearly 2½ times the then current level.

7. <u>The 1980 Study</u>* was written just after the second oil price shock, triggered off by the Revolution in Iran. Its thinking was coloured by proposals discussed in OPEC (which, at the time, seemed attainable) to increase the oil price in line with real economic growth in the West and by further evidence of slippage in the development of non-oil fuels. These factors outweighed the Study's projections of energy demand which were rather lower than in the preceding study. The Study concluded that, for 2000, an appropriate price range for planning purposes was $55-87, with a central estimate at $65 representing a rough doubling of the price over the period.

8. Leaving aside the first Study in 1974, each of these studies has projected a significant increase in price in the long term and also a much higher range of prices for 2000 than its predecessor. In the case of the 1975 and 1977 Studies, this was despite the reductions in energy demand assumed to result from the first price shock; and in the case of the 1980 Study, there was the further effect on demand consequent

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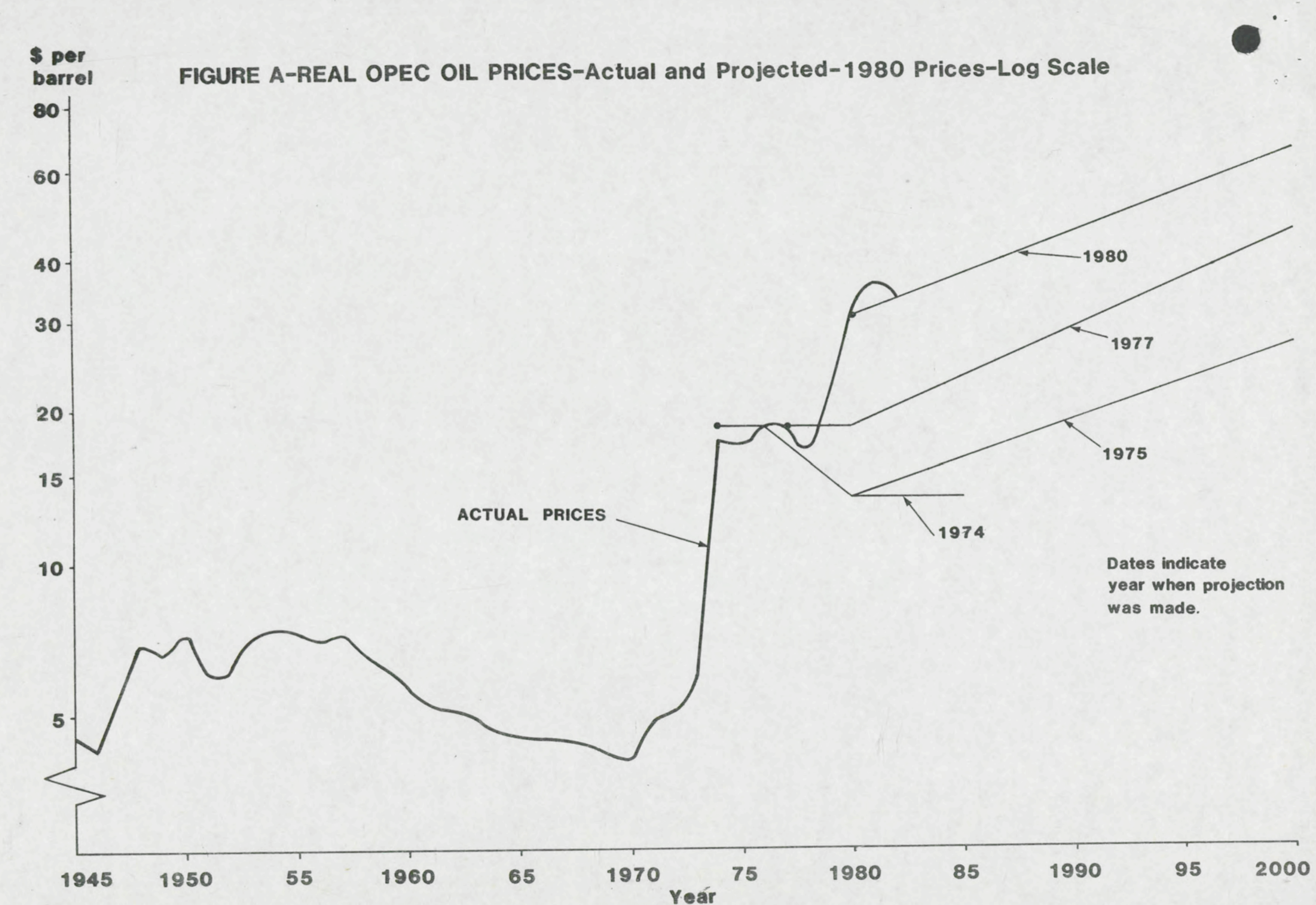
*A summary of this study was given in a Supplementary Memorandum by the Department of Energy to the Select Committee on Energy, reproduced in the Committee's minutes of evidence of 17 December 1981.



$ per
barrel
FIGURE A-REAL OPEC OIL PRICES-Actual and Projected-1980 Prices-Log Scale
80
60
40
30
20
15
10
5
1980
1977
1975
1974
ACTUAL PRICES
Dates indicate
year when projection
was made.
1945
1950
55
1960
65
1970
75
1980
85
1990
95
2000
Year

on the second shock. The main factors sustaining expectations of a rising oil price in the long term have been:

(i) increasing acknowledgement of OPEC's strength, along with declining estimates of OPEC countries' maximum production potential;

(ii) increasing doubts about the prospects for nuclear power;

(iii) rising cost estimates and production delays for the supply of crude oil from tar, shale and coal;

(iv) recognition that, the two price shocks notwithstanding, the rate of economic growth will be the principal factor determining energy demand in the longer term;

(v) above all, a view that a rising real oil price would be the outcome of a rising demand for depleting fossil fuel reserves.

III RECENT DEVELOPMENTS

9. Since the 1980 Study was written, the oil market has been weak, despite the Gulf War and other disturbances in the Middle East. Demand for oil has fallen considerably as a result of weak economic growth, increased efficiency of oil use, and substitution of other fuels. But there is not yet enough evidence to decide how much of the demand fall is due to short term and reversible factors and how much represents more lasting changes. This has widened the range of uncertainty about the size of the long term response of energy demand to price increases. As a result of the recent fall in demand, considerable surplus capacity has emerged in OPEC; earlier this year, OPEC output was little more than half its 1979 level. The possibility of demand remaining weak in the longer term raises questions about the effectiveness of OPEC at much lower levels of output. Despite these factors the real oil price in 1982 ($32½) is about 5% higher than in 1980, when the last Study was written.

10. These developments have set in train reappraisals of longer term price prospects, including this Study.

IV METHODOLOGY

11. The "oil price" referred to in this Study is the average price of OPEC crudes, all expressed in terms of the OPEC marker (Saudi Arabian light 34° API crude oil fob Ras Tanura.) It is expressed in real terms, based on 1980 world price levels. We have

chosen a 1980 price basis for technical reasons. Because world prices expressed in dollars are unlikely to have changed significantly between 1980 and 1982, use of a 1982 basis would have produced broadly similar results. For convenience, the numeraire used is the dollar, because this is the currency in which oil prices are set. However, this is not intended to indicate that if, over the long run, the dollar tends to be stronger or weaker relative to other currencies, then the oil price would be stronger or weaker. Rather, it is assumed that if the dollar were persistently stronger than in the base year, the dollar oil price would be lower, and vice-versa. Thus oil prices in the Study can, in effect, be regarded as given in terms of a broad currency basket.

12. Energy demand and supplies are all expressed in a common unit of measurement - millions of barrels of oil per day (mbd) or equivalent (mbdoe).

13. As in previous studies the first step is to make assumptions about economic growth in the World Outside Communist Areas (WOCA). Averaged over the period to 2000, these are a high case of 3½ per cent and a low case of 2¼ per cent. The build-up of these cases by region is shown in Table 2 below. Growth is assumed to be marginally lower than in the last study. In the high growth case it has been assumed that the world manages to get back to a rate of productivity growth somewhere between the growth of the 1970s and the high growth rates of the 1950s and 1960s. It would be difficult fully to recover the high growth rates of the 50s and 60s. That period was marked by non-repeatable post-war recovery gains (eg rapid expansion of world trade, with erosion of trade barriers; the diffusion of US technology gains to other countries; and productivity improvements resulting from labour force movement from agriculture to manufacturing). Their cumulative effect was to create a "virtuous circle" of growth that was reinforced by increasing access to abundant cheap oil and minerals on a scale which is unlikely to be repeated. The low growth assumption has productivity growth continuing at a marginally weaker rate than in the slow growing 1970s.

TABLE 2: GDP GROWTH RATES BY REGION SHOWING HIGH AND LOW ASSUMPTIONS 1980-2000

Region	OECD				LDCs			OPEC	WOCA (average)
	USA	Europe	Japan	Average	Low income	Oil exporters	NICs & S.Africa		
High growth	2.6	3.2	4.4	3.2	3.9	5.5	5.4	5.5	3.6
Low growth	1.6	1.6	2.2	1.9	2.8	4.0	3.8	4.0	2.3

14. For the oil price, two initial working assumptions have been used. These are a high case in which the price rises to $45 by 2000 and $60 by 2010; and a low case in which the price falls to $25 by 1985 and remains at that level through 2010. The high price case is roughly in line with the single starting assumption used in the 1980 Study. The low price case reflects some current suggestions about likely short term price developments and the possibility that the price may not change much in real terms over the longer term.

15. On the basis of these assumptions, we have constructed long term projections for energy supply and demand. The relationship between these projections indicates which way the price is likely to move. Actual energy prices tend to rise when demand exceeds supply and to fall when supply exceeds demand. The intersection of the hypothetical supply and demand projections determines the feasible ranges for the price on a range of assumptions about growth, conservation and energy supplies.

16. The aim in our approach is to eliminate combinations of economic growth, energy demand, energy supplies and the oil price which look highly unlikely. When these have been eliminated, feasible ranges remain within which the price could fluctuate. No allowance has been made for major surprises e.g the possibility that world growth will be outside the 2¼-3½ per cent range or that there will be an important and lasting gain or loss to fuel supplies. (Major surprises are discussed further in Section VII). However, the approach does provide for quite large variations in the supply and demand projections. A temporary loss of supplies would, in many cases, result only in a perturbation within the price range we identify. If the loss were substantial, the price might move outside the range for some years, but it should eventually move back within the range projected for the long term.

17. For the first time in this series of Studies, the period beyond 2000 is considered. For this period, an assessment has been made of whether the development of non-oil fuels could, by that time, increasingly limit the extent to which the oil price might rise.

18. As in previous Studies, oil (particularly OPEC oil) is treated as the marginal fuel, balancing world energy supply and demand. Three considerations justify this. First, oil will continue to have a role, albeit a diminishing one, as a general purpose fuel for heating and power at least for the rest of this century. Second, the supply to the consumer of fuels other than oil can usually adjust only slowly to sudden fluctuations in demand. Third, we expect some OPEC producers to have a margin of spare capacity which could be used to cope with such fluctuations in demand.

V ENERGY DEMAND

19. We have generated energy demand projections for the different growth cases and using different price assumptions. Rather than use single assumptions for the price and income elasticities we have drawn on the many analytical studies of energy demand and on our own work to choose a fairly wide range of assumptions about conservation. We have chosen assumptions to span the range of parameters used by most other experts and to be consistent with our own statistical analysis of energy demand in the last decade.

Disaggregation by region and sector

20. Energy demand is projected separately for industrial and developing countries because there are significant differences between them in the way in which energy is used and conserved. Within the developing countries group, separate projections have been made for OPEC, for other oil exporters, for the new industrialising countries (NICs), and for the low income countries. For the industrialised countries, energy demand has been analysed by sector - Transport, Domestic and Commercial, and Industrial users. For each sector, energy demand has been divided into electricity demand and the demand for other fuels, since these fuels are highly interchangeble, while electricity is less interchangeable and uses more primary energy per unit of delivered energy. We expect the bulk of the growth in energy demand to occur in the developing countries, because they should enjoy stronger economic growth than the industrialised countries, while their energy savings through conservation are likely to be smaller.

Construction of Energy Demand Projections

(a) Income Effects

21. GDP growth increases demand for energy, partly through income effects as a richer society demands higher standards of thermal comfort, more energy using devices and more transport, and partly because energy inputs are needed to fuel the higher pace of industrial activity. The sensitivity of energy demand to growth in GDP (its income elasticity) may vary, depending on the stage of a country's development, the pace of change of its industrial structure, the size of economies of scale, and changes in consumer preference. Table 3 below shows the range of income elasticities which have been used. Generally, for industrialised countries, the income elasticity ranges from about 1.0 to about 0.9 implying that, with constant prices, energy demand will tend to grow at around the same rate as GDP growth or a little slower. This range reflects different assumptions about the degree of scale economies available to the commercial and industrial sectors; the degree to which consumer energy demand rises with incomes; and the degree to which the recent decrease in energy demand reflects changes in the industrial structure. In developing countries, higher income elasticities have been used ranging from about 1¼ to about 1: this partly reflects growth in the use of commercial energy supplies, as traditional fuels such as firewood decline.

(b) Non-price Conservation trends

22. Most conservation appears as a response to higher energy prices and is captured in the price sensitivity discussed below. However, we also allow for the possibility of technical progress, energy saving innovations and improved working methods leading to reductions in demand independently of income and price effects. These conservation trends are also shown in Table 3.

TABLE 3: RANGE OF INCOME ELASTICITIES AND CONSERVATION TRENDS

		High Conservation Case		Low Conservation Case	
		Income Elasticity	Trend % pa	Income Elasticity	Trend % pa
OECD:	Industry	0.8	-½	0.9	-¼
	Domestic & Commercial	0.9	-½	1.0	-¼
	Transport	1.0	-1	1.1	-½
LDCs	NICs and S.Africa	1.0	nil	1.1	nil
	Oil exporters	1.1	nil	1.2	nil
	Low income	1.1	nil	1.3	nil
OPEC	High absorbers	1.0	nil	1.2	nil
	Low absorbers	1.05	nil	1.2	nil

(c) Price effects

23. Increases in energy prices relative to other prices induce reductions in demand as energy consumers switch towards other sources of comfort, tighten energy management, increase insulation and switch to newer, more energy-efficient plant. Some of these responses can occur soon after a price rise; others can be delayed until existing plant gets nearer to its originally planned replacement date. The speed of these responses, the lag structure, strongly influences the pattern of energy demand. As part of the conservation range, two lag hypotheses have been adopted in this study: a short lag structure, in which half of the fall in demand comes through in the first 5 years after a price increase; and a longer lag structure over 20 years, in which half of the effect comes through in the first 8 years.

24. Detailed assumptions about the response of energy demand to final user prices are shown in Table 4 below. Again we have used high and low figures for these elasticities to give a plausible spectrum of results, reflecting the large measure of uncertainty. The upper and lower elasticities were derived from our own statistical studies designed to obtain the likely boundaries; they span the assumptions used by most commentators. The elasticities are assumed to be much lower for OPEC and the LDCs than for the OECD and the New Industrialised Countries (NICs). This is because, in general, LDCs have fewer opportunities to substitute capital for energy in their production processes.

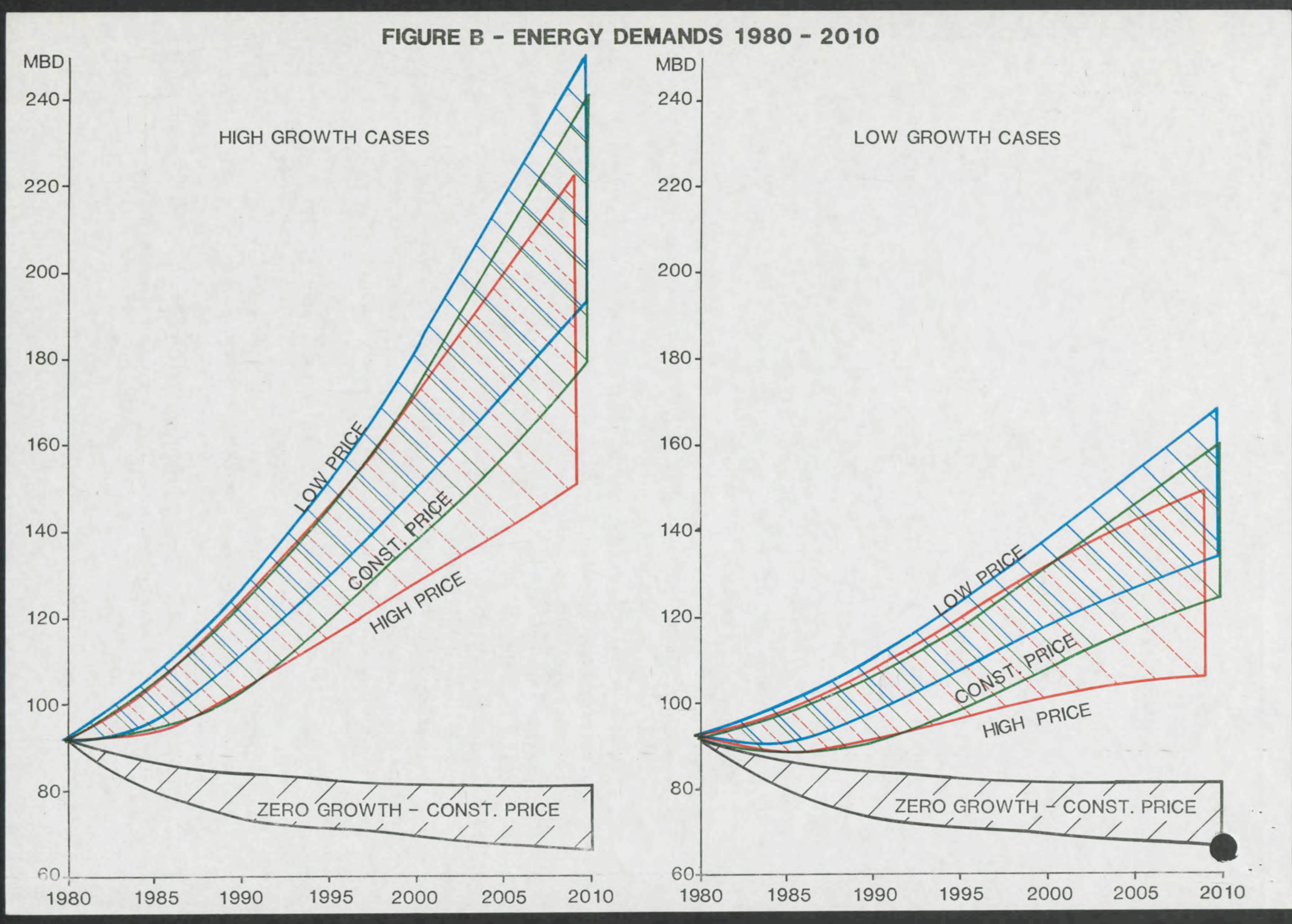


FIGURE B - ENERGY DEMANDS 1980 - 2010
MBD
240
220
200
180
160
140
120
100
80
60
HIGH GROWTH CASES
LOW PRICE
CONST. PRICE
HIGH PRICE
ZERO GROWTH - CONST. PRICE
1980
1985
1990
1995
2000
2005
2010
MBD
240
220
200
180
160
140
120
100
80
60
LOW GROWTH CASES
LOW PRICE
CONST. PRICE
HIGH PRICE
ZERO GROWTH - CONST. PRICE
1980
1985
1990
1995
2000
2005
2010

TABLE 4: PRICE ELASTICITY ASSUMPTIONS FOR ENERGY DEMAND

		High Conservation Case	Low Conservation Case
OECD	Industry	-0.7	-0.3
	Domestic and Commercial	-0.7	-0.3
	Transport	-1.0	-0.5
LDCs*	NICs & S Africa	-0.7	-0.4
	Oil exporters	-0.4	-0.2
	Low income	-0.5	-0.2
OPEC*	Low absorbers	-0.3	0
	High absorbers	-0.4	-0.2

*In the case of LDCs and OPEC, these are average elasticities for the whole period. It was assumed that the income elasticity would fall and the price elasticity rise over the period.

Energy Demand Results

25. Figure B illustrates the results of our demand analysis for the WOCA. If economic growth were to be zero and the oil price constant (the lower segments shown), the analysis indicates that energy demand would fall by about ½% - 1½% pa. This would reflect the conservation response to the oil price shocks of 1973 and 1979, as the capital stock is replaced with energy efficient plant. The green upper segments show how the cumulative effect of economic growth (at constant energy prices) would gradually overwhelm the conservation response to past price rises. Total energy demand is shown to rise by ½% to 1½% a year in the low growth case and by 2% to 3% a year in the high growth case. In both cases the rise in energy demand is less than the growth of output principally because of the continuing response to past price rises. The red segment in Figure B indicates the effect of the higher price assumption, and the blue segment the lower price assumption. Broadly, the higher price profile reduces the demand range by about ½% a year, and the lower price raises it by ¼% a year.

26. Figure C shows the breakdown of a typical set of demand projections on the higher starting price assumption but where economic growth assumptions have been averaged. It shows demand growing at 4% to 5½% a year in OPEC and 3%-4¼% in the LDCs; while energy demand in the industrialised countries is projected to grow at ½% to 2% a year. In the industrialised countries, a switch to electricity is a feature of the projection and, although travel demand is thought likely to be buoyant, increased efficiency of the transport fleet seems likely to contain the growth of energy used for transport.

27. Table 5 gives our energy demand projections upto 2000. The energy demand growth rates are in all cases significantly higher in the 1990s than the 1980s. Demand growth is lower with higher prices. In 2000, demand in the higher growth cases is about 30-40mbd greater than with low growth. Demand in the high conservation cases is 20-40mbd less than in low conservation cases.

TABLE 5 **WOCA ENERGY DEMAND**

mbdoe

Oil Price	Economic Growth	1980	1990	2000	Annual % Growth 1980-2000
High	High		102-122	126-168	1.6-3.0
High	Low		90-106	99-128	0.4-1.7
		92			
Low	High		109-126	149-179	2.4-3.4
Low	Low		97-109	117-137	1.2-2.0

28. Whilst these projections assume that the effects of economic growth, price and the degree of conservation are independent of each other, that is unlikely to be the case. In particular, lower economic growth with a consequently slower turnover of the capital stock, may not create favourable conditions for higher conservation so that the lower end of the low demand ranges is less likely. Of course, not all the price paths tested in this demand analysis are possible and to determine which pathways are feasible it is necessary to show the interactions between energy demands and energy supplies for each price path. (See Section VII.)

29. The demand projections allow us to trace in demand schedules showing for a particular year how much energy would be demanded at different price levels on the different economic growth and conservation assumptions. Figure D shows what these schedules would look like for the year 2000 on a wider range of prices than those used in the starting assumptions, assuming that the price adjusts smoothly to those levels.

VI ENERGY SUPPLIES

30. In this Section, the prospects for each of the primary sources of energy for WOCA are considered. The estimates have been built up region by region from studies of fuel reserves, combined with assumed rates of likely extraction and by taking account of production and investment plans for non-fossil fuels. Estimates of energy exports from Communist countries are then added to the total. A range of possible supplies is shown for each fuel. Different assumptions about economic growth and the

FIGURE C-COMPOSITION OF FREE WORLD ENERGY DEMAND. FOR "HIGH PRICE"-"AVERAGE GROWTH" CASE

MBDOE

OPEC

LDC'S

OECD

200

150

100

50

HIGH

LOW

HIGH

LOW

1980 1990 2000

DEMAND GROWTH 1980-2000%p.a

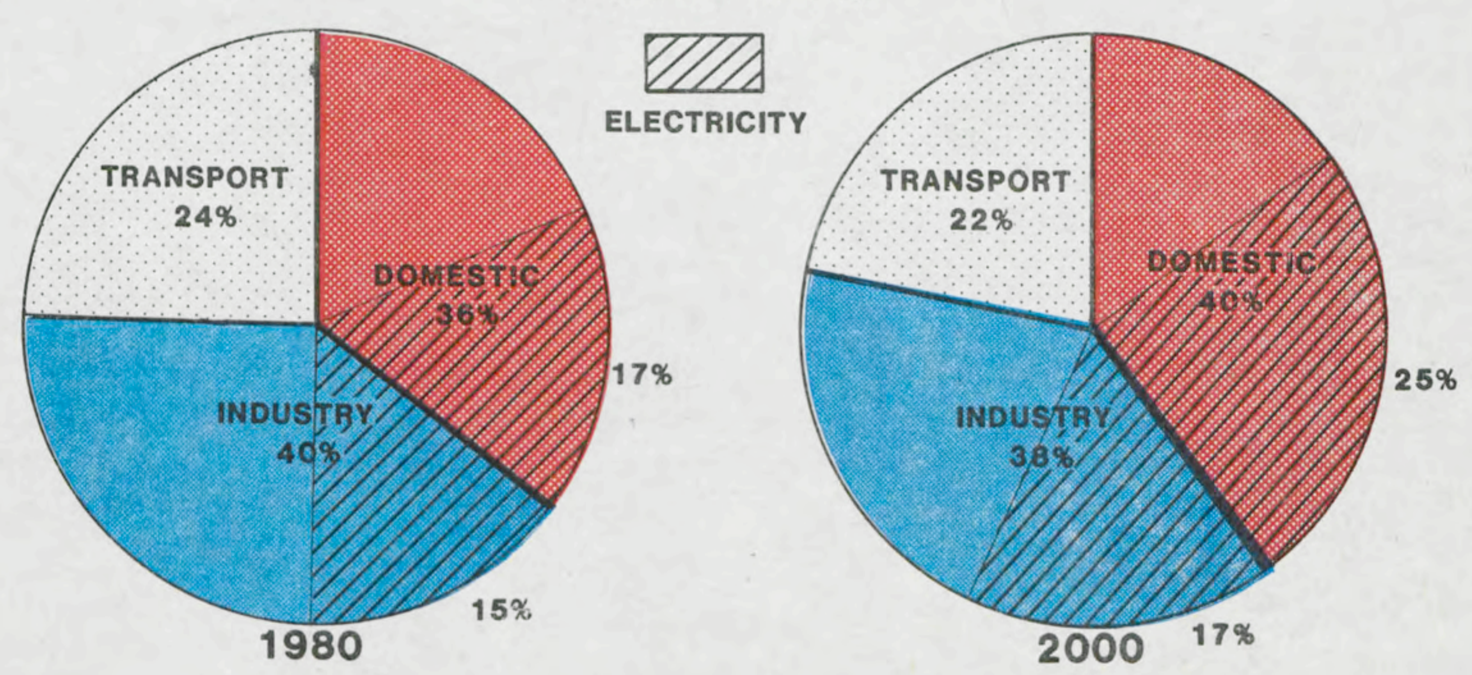
OPEC 4.1-5.4

LDC'S 2.9-4.2

OECD 0.3-1.8

TOTAL 1.0-2.4

OECD DEMAND SHARES PRIMARY ENERGY



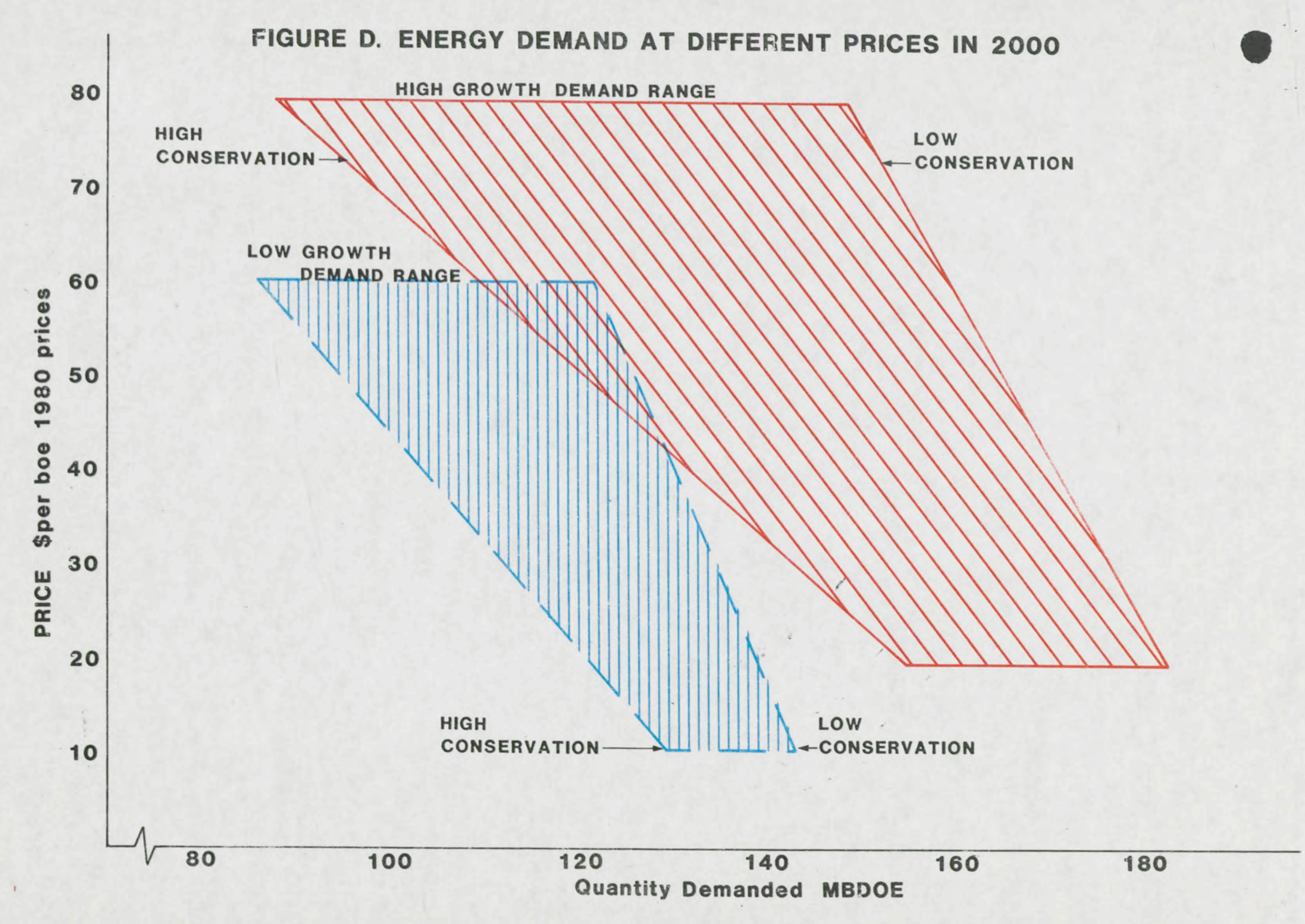


FIGURE D. ENERGY DEMAND AT DIFFERENT PRICES IN 2000
HIGH GROWTH DEMAND RANGE
HIGH CONSERVATION
LOW CONSERVATION
LOW GROWTH DEMAND RANGE
HIGH CONSERVATION
LOW CONSERVATION
PRICE $per boe 1980 prices
80
70
60
50
40
30
20
10
80
100
120
140
160
180
Quantity Demanded MBDOE

oil price (described in paragraphs 13-14 above) and the uncertainty about new energy finds and technological developments generate the ranges.

31. We think that, apart from coal, high growth will tend to increase fuel supplies because of its association with more rapid technological advance and greater economic dynamism. We also think that the price of energy will have a significant effect in bringing forward or postponing marginal developments, though time lags may be considerable, and price expectations may intervene. The ranges shown for uncertainty do not attempt to cover all possibilities; they were chosen to cover the more plausible outcomes.

(a) Coal

32. These projections are broadly in line with those in the 1980 study:

Economic Growth	Oil price	1980 actual	1990	2000	mbdoe 2010
Low	Low	18.5	22	26-28	32-36
Low	High		25-27	33-37	43-49
High	Low		21-22	24-25	27-30
High	High		24-26	31-35	40-46

Note: The projections include supplies of brown coal and peat; the latter could account for about 2 mbdoe by 2000.

33. Reserves of coal are large enough to support production at many times current levels. But these reserves will be exploited only if the price is high enough to cover costs and yet low enough compared to other fuels, especially oil, to make the use of coal attractive. Even if the price is right, expansion of coal supplies could be delayed by the long lead times involved in developing new mines, environmental opposition (particularly in the case of opencast mining), and the need to build the necessary infrastructure to permit increased international trade in coal.

34. The level of coal supplies by 2000 will depend upon how much coal prices rise compared with marginal costs. At the lower output levels shown in the table, marginal costs will be lower and those output levels could be delivered with a 1 per cent a year rise in coal prices. The higher oil price levels could permit coal prices to rise by 2 per cent a year and this would allow marginal costs to be met at higher output levels. Higher economic growth is likely to mean higher costs in the coal industry. The major expansion in coal output foreseen for the high oil price case occurs in the USA, Australia and S.Africa. Lower coal prices would reduce output in all these countries

to some extent but eastern USA, which is generally seen as a marginal supplier of world coal trade, would be most affected.

(b) Gas

35. Our projections of gas supplies are now slightly lower than those made in the 1980 study:

Economic growth	Oil price	1980 actual	1990	2000	mbdoe 2010
Low	Low		16-19	13-18	12-19
Low	High		18-21	17-24	16-27
		16.6			
High	Low		17-19	14-20	13-21
High	High		19-22	18-26	18-29

36. Gas output is now predominantly in OECD countries, where production is expected to fall over the period (though price-deregulation in the USA, if it goes ahead, could affect this trend). The main uncertainty is how far output will expand in a number of OPEC countries and other LDCs, particularly Mexico.

37. With fast economic growth and a high oil price, gas output from OPEC countries could treble by 2010, with notable increases in Algeria, Indonesia, Iran, and Nigeria. At the high oil price, expensive gas transportation projects would become sufficiently attractive to make producers willing to accept the investment risks and difficulties involved, while high economic growth should increase demand. But, even given these propitious circumstances, there is considerable uncertainty about how many projects would be implemented. International trade in gas involves heavy expenditures in liquefaction plant or pipelines, with consumers and producers committing themselves in long term contracts. The question is whether there will be sufficient mutual confidence between potential OPEC suppliers and their customers in industrialised countries to get additional export facilities built; this is likely to be an important consideration in the Middle East in view of the political uncertainties there. Although at least some of the new projects are likely to go ahead, the wide range of gas supplies projected for the long term reflects the large measure of uncertainty attached to the future of trade in gas.

38. On the low growth/low oil price assumptions, we think that some OPEC countries would be more interested in expanding gas exports because their revenues from oil would probably be insufficient to finance even modest development plans. Against that, a low oil price would put a ceiling on gas prices and, because of the higher costs involved in gas production, would reduce returns to gas producers disproportionately.

Any expansion of OPEC and LDC supplies in these circumstances may do little more than offset the decline in output among industrialised countries.

(c) Nuclear

39. Nuclear power was responsible for 12 per cent of electricity generation in 1980. And at current oil prices, it is cheaper than oil in generating electricity. Up to 1990, its expansion is largely determined already, because of long lead times on nuclear investment. Later, the range of possibilities widens considerably:

mbdoe

Economic Growth	Oil Price	1980 actual	1990	2000	2010
Low	Low	2.9	4-6	6-9	7-12
Low	High		5-6	7-11	9-14
High	Low		5-7	9-12	11-16
High	High		6-8	10-15	12-24

The projections for 2000 are some 3-5 mbdoe less than those in the 1980 study.

40. In the longer term, political considerations and public acceptance are likely to be crucial in determining the degree of nuclear expansion and this is reflected in the ranges above. Stronger economic growth and a higher oil price might reinforce the case for nuclear power and could help to secure a greater degree of public acceptance. Opposition to nuclear could diminish in the absence of accidents and through demonstration of effective safety measures. But doubts about the growth of electricity demand and also the heavy capital cost of nuclear plant could slow down development.

(d) Hydro-electric power and other Renewable Sources

41. The principal renewable energy resource is likely to remain hydro-electric power. Contributions from other sources - wind, solar, etc - will probably be fairly

small; even though R&D work will be extensive, widespread commercial usage seems unlikely within the period of the study. Our projections are as follows:

mbdoe

Economic Growth	Oil Price	1980 actual	1990	2000	2010
Low	Low		8	9	9-10
Low	High	6.4	9	9-10	11-12
High	Low		9	10	12-13
High	High		9	11-13	13-16

The projections for 2000 are some 2-4 in mbdoe less than those in the 1980 study.

42. As with nuclear, the prospects for hydro-electric power to 1990 are already largely determined because of long lead times. Beyond that, there is scope for expansion, particularly in LDCs, as new hydro plant can generally provide cheaper power than oil, even under the lower working assumption of a $25 oil price. The pace of expansion will depend largely on expectations about growth in electricity demand in regions where hydro development is feasible.

43. Over the next twenty years or so, output of renewables other than hydro-electric is likely to grow slowly. By 2000, it could be limited to less than ½ mbd if growth and prices are low. Even with stronger growth and a high oil price, circumstances in which governments might give more support to development of renewables, their contribution may not rise much above 1 mbd. But some renewables should play a significantly greater role in the 21st century.

(e) Oil

44. We have considered future oil production in three main categories: conventional oil supplies outside OPEC, OPEC capacity, and non-conventional supplies (eg syncrude). For conventional oil, we have surveyed the estimates of total known reserves and have based our production estimates on the rates of depletion which we thought plausible without damaging ultimate recovery. World known reserves would last for about 30 years at present rates of production but our estimate of ultimately recoverable reserves could sustain current rates of consumption for 60 to 100 years. Prospects for OPEC capacity are considered separately in paragraphs 47-48 below and OPEC supplies are considered further in Section VII.

45. Our projections for the remaining two categories are set out below:

Conventional Oil (excluding OPEC)

mbd

Economic Growth	Oil Price	1980 actual	1990	2000	2010
Low	Low		19-22	18-22	16-21
Low	High		23-26	22-27	21-27
		19.8			
High	Low		19-22	18-22	16-21
High	High		23-26	22-27	21-27

Production is likely to decline in OECD countries and to increase in LDCs. How far total non-OPEC supplies increase will depend largely on the incentives for exploration, development, and production provided by the oil price.

Non-Conventional Oil

mbd

Economic Growth	Oil Price	1980 actual	1990	2000	2010
Low	Low		½-1	½-2	1-4
Low	High		½-2	2-7	5-14
		0.3			
High	Low		½-1	½-2	1-4
High	High		½-2	2-7	5-14

Note:

The projections for coal and gas supplies in paragraphs 32 and 35 omit the amounts of these fuels which we think could be used in projects to convert them to oil; the associated quantitities of oil are included in the table above.

These projections include heavy oil, oil extracted from tar sands and shale, and synthetic oil manufactured from fossil fuels (coal or gas) or from biomass. As with supplies of conventional oil, the oil price should be the key determinant of production.

OPEC Oil Capacity

46. The upper limit to OPEC production at any point will be determined by the installed production capacity. The high-absorbing members of OPEC are mainly low-income developing countries, and several of them are likely to become net energy importers during the period under review. It is likely that they will install sufficient

oil production capacity to enable them to produce at the maximum level which will not harm ultimate recovery and that they will aim to use their full capacity continuously. OPEC members around the Gulf will have rather more flexibility. Their oil reserves are much greater relative to their revenue needs, so they are unlikely to build up their productive capacity as rapidly as their reserves will allow. Capacity in the Gulf States may be influenced not only by their estimates of what could be required for revenue purposes but also by a desire to have a margin of spare capacity so as to permit flexibility in production policy. Our projections of OPEC's maximum production capacity are:

mbd

	1982 actual	1990	2000	2010
Gulf	19½	22-26	21-27	21-29
Non-Gulf	10½	7-9	6-7	5-7
Total OPEC	30	29-35	27-34	26-36

47. While the table above shows the expected range of maximum capacity, actual output will depend on a number of factors, including oil demand, the nature of OPEC's pricing and market-sharing policies, and the extent of any supply disruptions. These are considered in Section VII below.

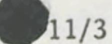
(g) Net Energy Exports from Communist Countries

48. The projections are as follows (the range covers each of the four combinations of economic growth and oil price starting assumptions):

mbdoe

1980 actual	1990	2000	2010
+1.8	-½ to +½	+½	+1 to +1½

49. It is likely that the Communist countries (the USSR, China, Eastern Europe and other centrally planned LDCs) will have a small energy surplus with the non-Communist world during the period. During the 1980s the surplus may decline to low levels owing to lower oil production in the USSR and slower growth in Poland's coal output, slower growth in both oil and coal production in China, and a continuation of the growth in domestic energy consumption (although at lower levels than in the 1970s). Although the USSR will remain a net exporter of energy, with additional gas exports partly off-setting the projected decline in oil supplies, the energy position of the Comecon countries as a whole could be in balance by 1990. The energy import



requirements of Eastern Europe should continue to rise, because of the limited availability of domestic supplies. In addition, if the Soviet Union's oil exports decline, then Eastern Europe will need to buy an increasing quantity of its oil from the world market. Thus the actual levels of the region's energy imports will depend on its foreign exchange position in the 1980s. There are many uncertainties beyond this period. During the 1990s the Communist countries' energy surplus could increase slightly to the extent that there are further increases in gas production in the USSR and development of off-shore oil fields in China.

Overall Energy Supply Position

50. Projections for total WOCA energy supplies, including net exports from Communist countries, are shown in Table 6 below for each of the price and economic growth starting assumptions. The ranges of uncertainty reflect optimistic and pessimistic assumptions about the developments of fuel supplies and technologies. At the upper end of the ranges, OPEC output is included at the maximum capacity levels shown in paragraph 46. At the lower end, OPEC output is entered at the minimum levels which we think OPEC could sustain on the strongest assumptions about its cohesion in defence of price objectives; we estimate this at about 20 mbd up to 1990 and at around 25 mbd in 2000 and beyond. The Table shows that the growth assumptions have little effect on the energy supply projections compared with the effect of price and the range of uncertainty; by 2000 the price assumptions and the range of uncertainty each give about 20 mbd difference, the growth assumptions about 5 mbd.

TABLE 6: WOCA ENERGY SUPPLIES

Oil Price	Economic Growth	OPEC Low Output		OPEC High Output		Annual Growth %
		1990	2000	1990	2000	1980-2000
High	High	102-110	124-141	117-125	134-151	1.4-2.4
High	Low	101-108	120-135	116-133	130-145	1.3-2.2
Low	High	92-98	103-113	107-113	113-123	0.5-1.4
Low	Low	91-97	100-111	106-113	110-121	0.3-1.3
OPEC output included		20	25	35	35	

Notes:
(i) 1980 total energy supply was 93½ mbdoe.

(ii) The range of uncertainty for the total is narrower than the sum of the ranges for each fuel, because being at the end of the range for all fuels in the same year is less likely than for any one fuel.

51. Figure E shows the ranges within which WOCA energy supplies are likely to develop under the two starting price assumptions (as in paragraph 14). Two variants are shown for each price path; the high variant has high economic growth, non-OPEC supplies at the top of the range of uncertainty and OPEC production at maximum capacity; the low variant has low economic growth, non-OPEC supplies at the bottom of the range of uncertainty and restrained OPEC production.

52. For each of the four variants described above, Figure F shows the share of each fuel in WOCA energy supplies. In the low price cases, most of the growth in energy supplies between 1980 and 2000 comes from the growth in coal capacity. Although nuclear shows a rapid growth, it starts from a low base. In the high price cases, coal accounts for about one third of the growth in energy supplies. Nuclear and renewables contribute a similar amount, with some growth also in oil and gas. The range is widest for oil, because of the potential variation in OPEC supply. This study shows a smaller growth in renewables and unconventional oil than earlier assessments. Projects have been postponed recently because of expectations of softer oil prices throughout the 1980s, but if the necessary investment eventually goes ahead, they could make an increasing contribution to energy supplies after 2000. Overall, energy supplies are shown to be growing at about ½ per cent to 1½ per cent a year on low price assumptions and by1½ per cent to 2½ per cent a year on high price assumptions.

FIGURE E - WORLD ENERGY SUPPLIES AT DIFFERENT PRICES AND GROWTH RATES

MBDOE

160

140

120

100

80

60

40

20

0

ACTUAL

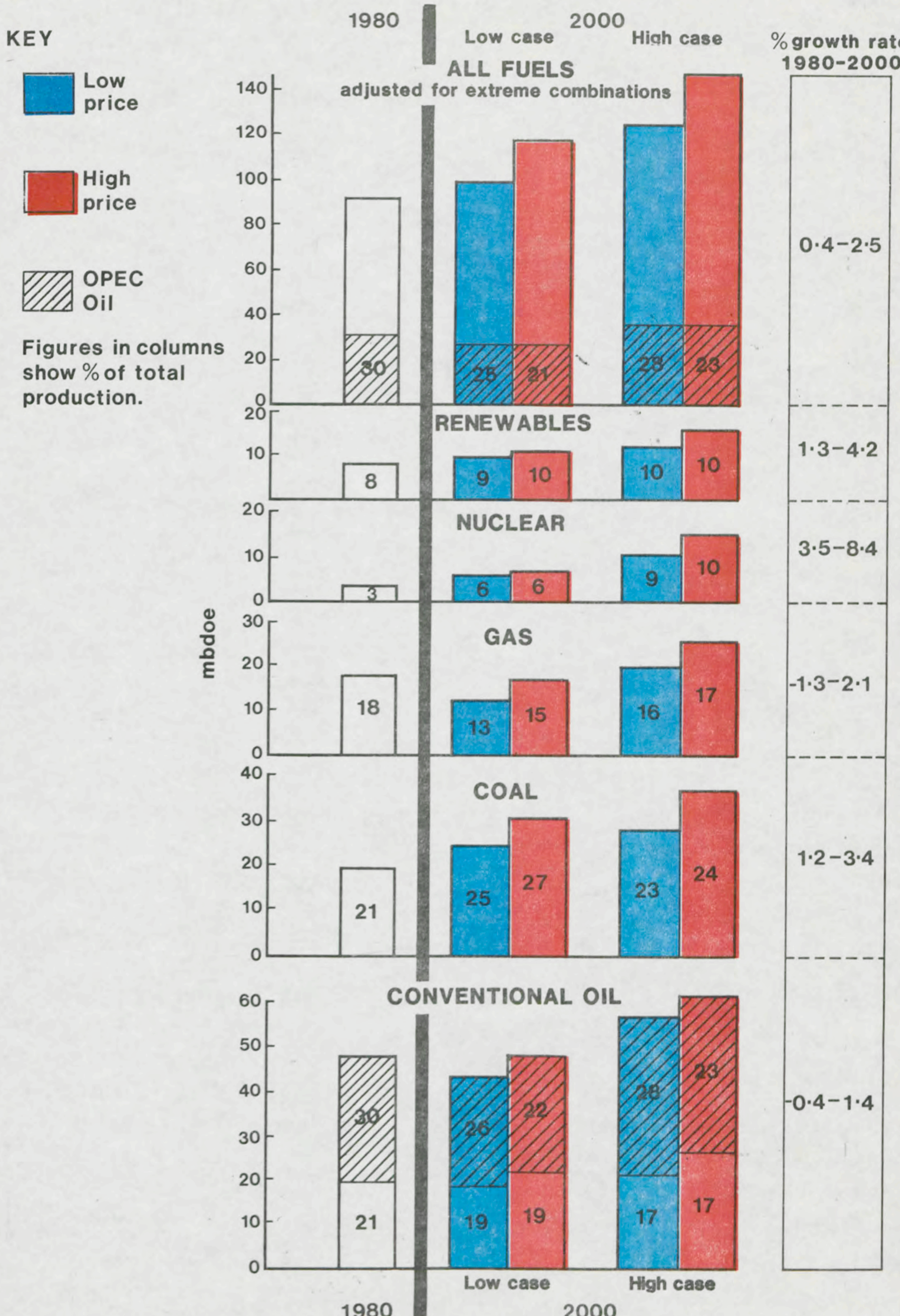
PROJECTED

1970 1975 1980 1985 1990 1995 2000

Energy supply range at high price

Energy supply range at low price

Figure F : SENSITIVITY OF WOCA ENERGY PRODUCTION IN 2000 TO ASSUMPTIONS MADE



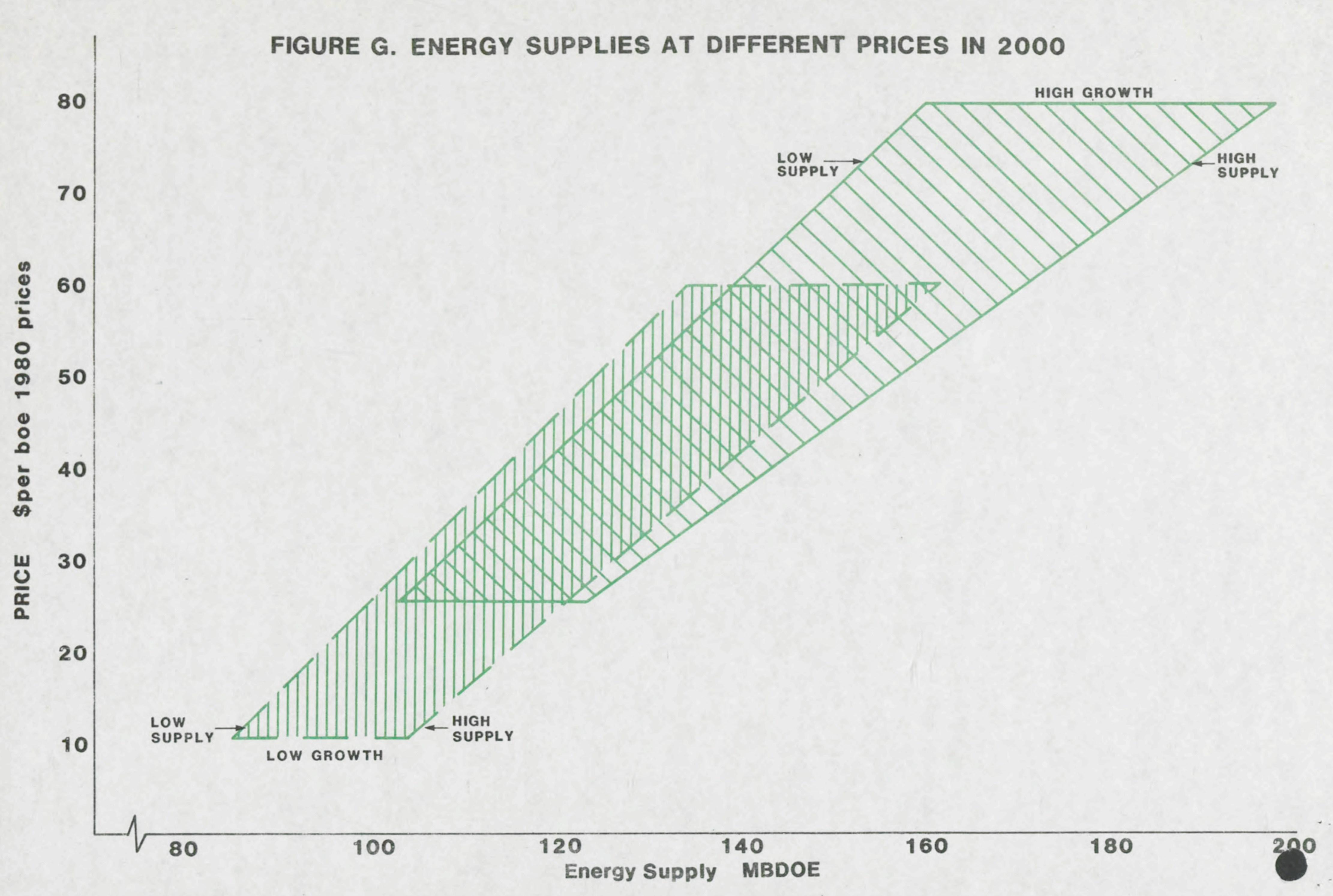


FIGURE G. ENERGY SUPPLIES AT DIFFERENT PRICES IN 2000
PRICE $per boe 1980 prices
80
70
60
50
40
30
20
10
HIGH GROWTH
LOW SUPPLY
HIGH SUPPLY
LOW SUPPLY
HIGH SUPPLY
LOW GROWTH
80
100
120
140
160
180
200
Energy Supply MBDOE

53. The estimated relationships between energy prices and energy supplies enable a supply schedule to be drawn up on the lines of Figure G for the different years. For 2000, the Figure shows the upper and lower end of the supply ranges at different prices, assuming that the price adjusts smoothly to these levels. Higher growth is shown as increasing energy supplies. In the next Section, we show the interaction between these supply paths and the energy demand paths.

VII ENERGY BALANCES AND PRICE DEVELOPMENTS

54. Before putting together our energy supply and demand projections, we consider OPEC's position. As indicated in paragraph 47, OPEC have some flexibility in production policy and thus could influence the price. But their policy will also be affected by the import requirements of their development plans and their wider political objectives.

55. The recent weakness in the oil market has sharply increased the difficulties for OPEC countries in taking the collective action necessary to maintain prices and revenues, but has underlined their common interest in preventing a sharp fall in the price. The tension between high and low absorbers may increase as the latter group's room for manoeuvre on production levels is eroded by growing import requirements and by price weakness. But no OPEC member would gain if the price collapsed, and this will be an incentive for the Organisation to stick together and avoid undermining their pricing arrangements. Political difficulties may be at least as great an impediment as diversity of economic interest. Given the volatility of the region, policy changes among Middle Eastern producers which could radically affect production cannot be ruled out. Among the areas to watch will be the Arab/Israel dispute; any tendency for Islamic assertiveness to increase; and the effects of rapid economic development on the stability of the traditionalist states.

Possible OPEC output levels

56. In order to estimate the likely range for the oil price, we are interested in the range of OPEC output levels which are realistically sustainable. We have attempted to estimate the residual demand for OPEC oil. Table 7 puts together the energy demand estimates shown in Table 5 and the supply projections (excluding OPEC oil) drawn from Table 6. For each case, broad ranges are obtained by combining low conservation with low supply and high conservation with high supply.

TABLE 7 RESIDUAL DEMAND FOR OPEC OIL
(ENERGY DEMAND less NON-OPEC SUPPLY)

mbd

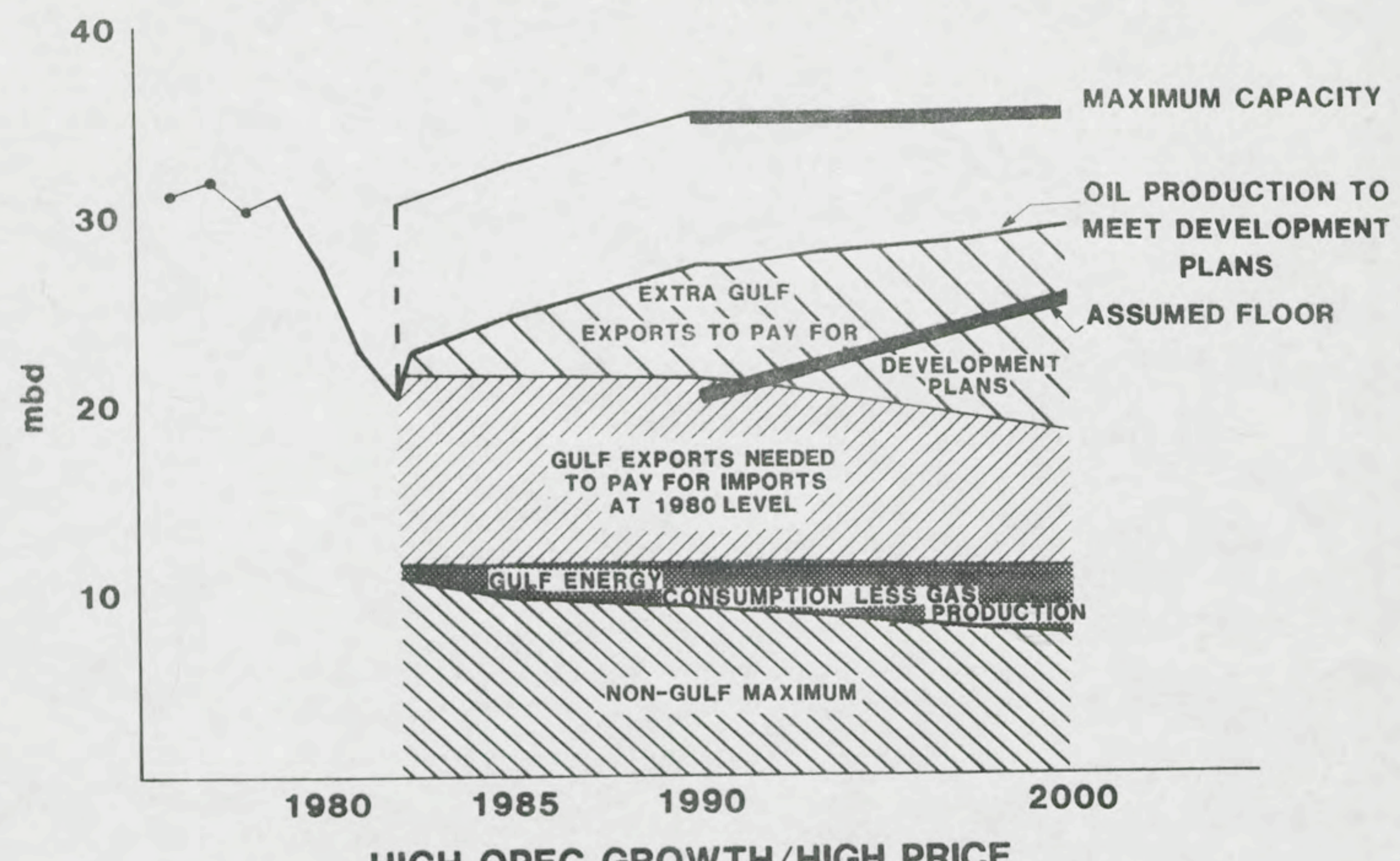
Price	Growth	1980	1990	2000
Low	Low	27	19 to 38	31 to 61
Low	High		32 to 54	60 to 101
High	Low	27	2 to 25	-10 to 34
High	High		12 to 40	11 to 69

Note: A negative residual would require OPEC oil imports to balance the system.

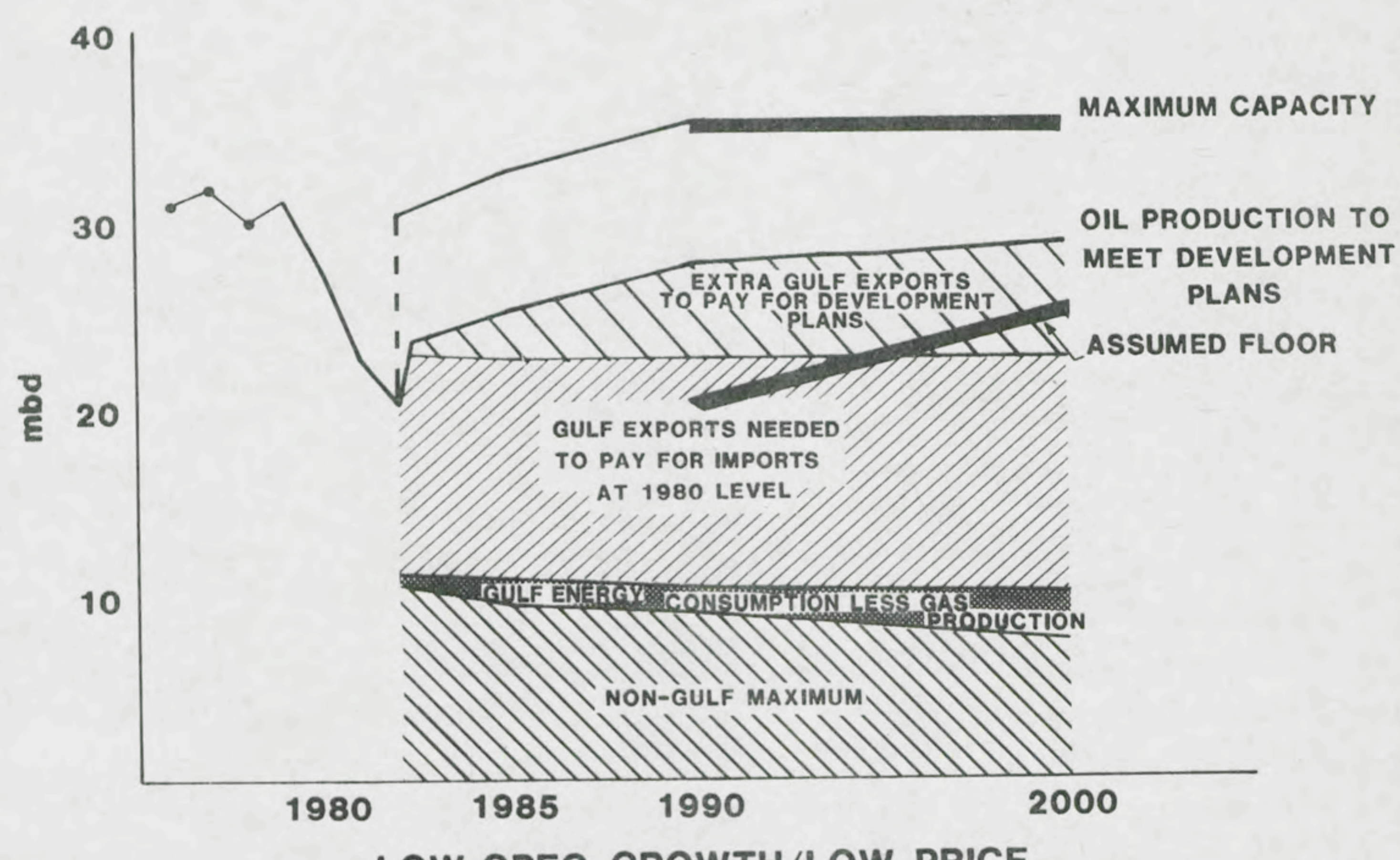
57. Comparing the demand levels with the range for their output indicates the possible extent of OPEC market power. Figure H shows a number of influences on this range. The bottom segment shows non-Gulf OPEC members, who are assumed to produce at the top of the range of their estimated capacity. The upper segments of the figure add on the more discretionary output levels of Gulf OPEC. The minimum realistic production level would arise if the Gulf countries were to hold total OPEC production level to 20 mbd (a similar level to 1982). Beyond 1990, we think that the Gulf States' own energy needs and development plans, even if severely cut back, would force the minimum OPEC output level up to about 25 mbd. Maximum production levels would only arise if OPEC members were to produce at maximum capacity (without regard to price objectives). There are, of course, a number of possibilities within these boundaries.

58. This analysis suggests that OPEC power to influence long run price developments depends on their willingness to continue holding output below capacity. Some OPEC members will be extremely reluctant to do this; their revenue requirements will make them unwilling to cut production. But, in support of OPEC price objectives, the richer Gulf members may be able to vary their output enough to give a production range for OPEC as a whole, which is illustrated in Figure H. This range is from 20 to 30/35 mbd in the 1980s and from 20/25 to 35 mbd in the 1990s. OPEC producing at 25 mbd rather than 35 mbd would increase prices over the period to 2000 by about $10, after taking into account other demand and supply reactions, bringing the price nearer to the levels implied by the long run supply of non-fossil fuels. In the short run, supply and demand elasticities are smaller, and so changes in OPEC output can exert more dramatic influences on the short term paths around these long term trends. However, since OPEC start off in 1982 in a phase of market weakness, we think that (in the absence of accidents) prices in the 1980s are unlikely to jump significantly above long term trends.

FIGURE H: INFLUENCES ON OPEC OUTPUT LEVELS



HIGH OPEC GROWTH/HIGH PRICE



LOW OPEC GROWTH/LOW PRICE

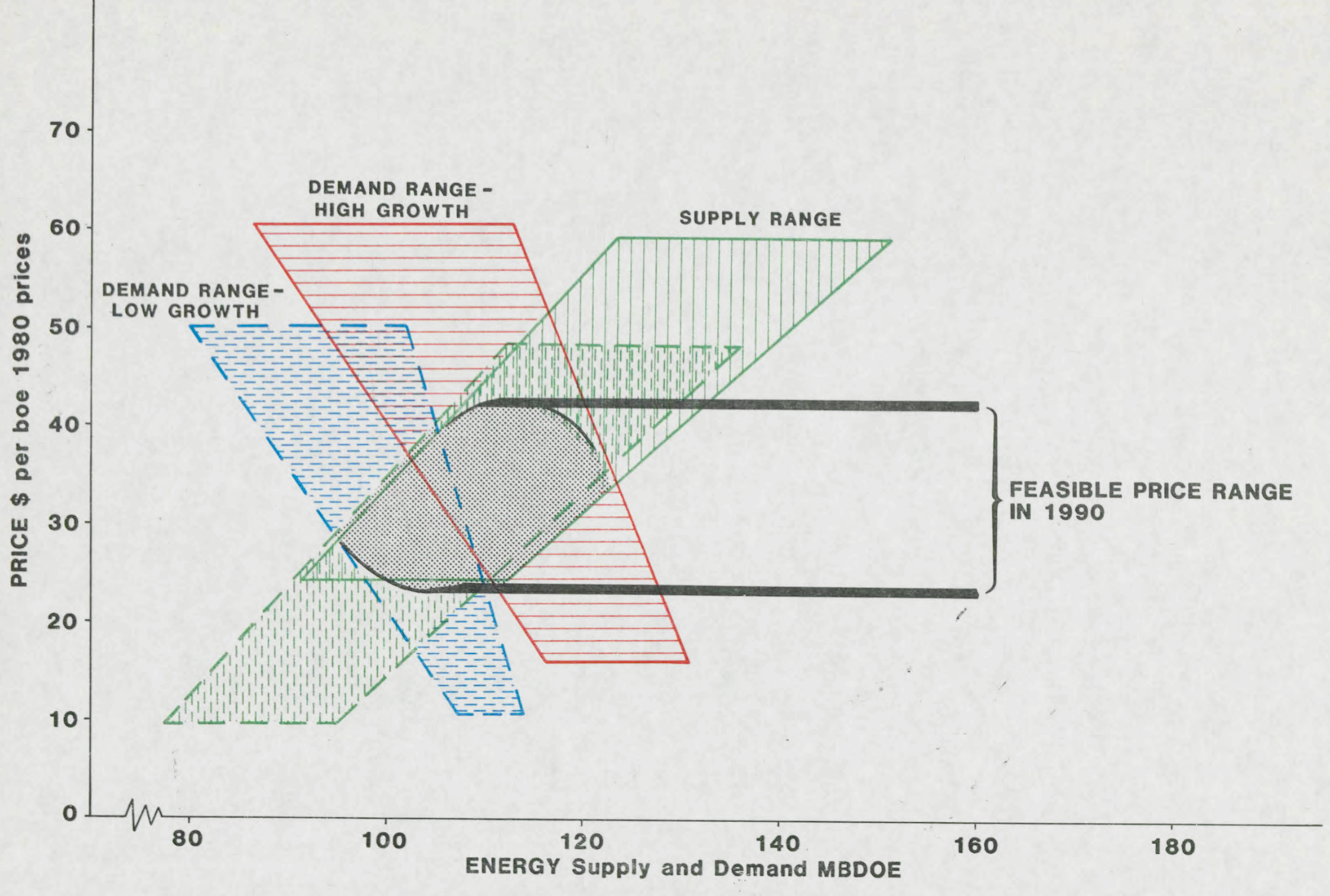


FIGURE I - ENERGY DEMANDS, SUPPLIES AND FEASIBLE PRICE RANGES IN 1990
DEMAND RANGE - HIGH GROWTH
SUPPLY RANGE
DEMAND RANGE - LOW GROWTH
FEASIBLE PRICE RANGE IN 1990
PRICE $ per boe 1980 prices
ENERGY Supply and Demand MBDOE
0
10
20
30
40
50
60
70
80
100
120
140
160
180

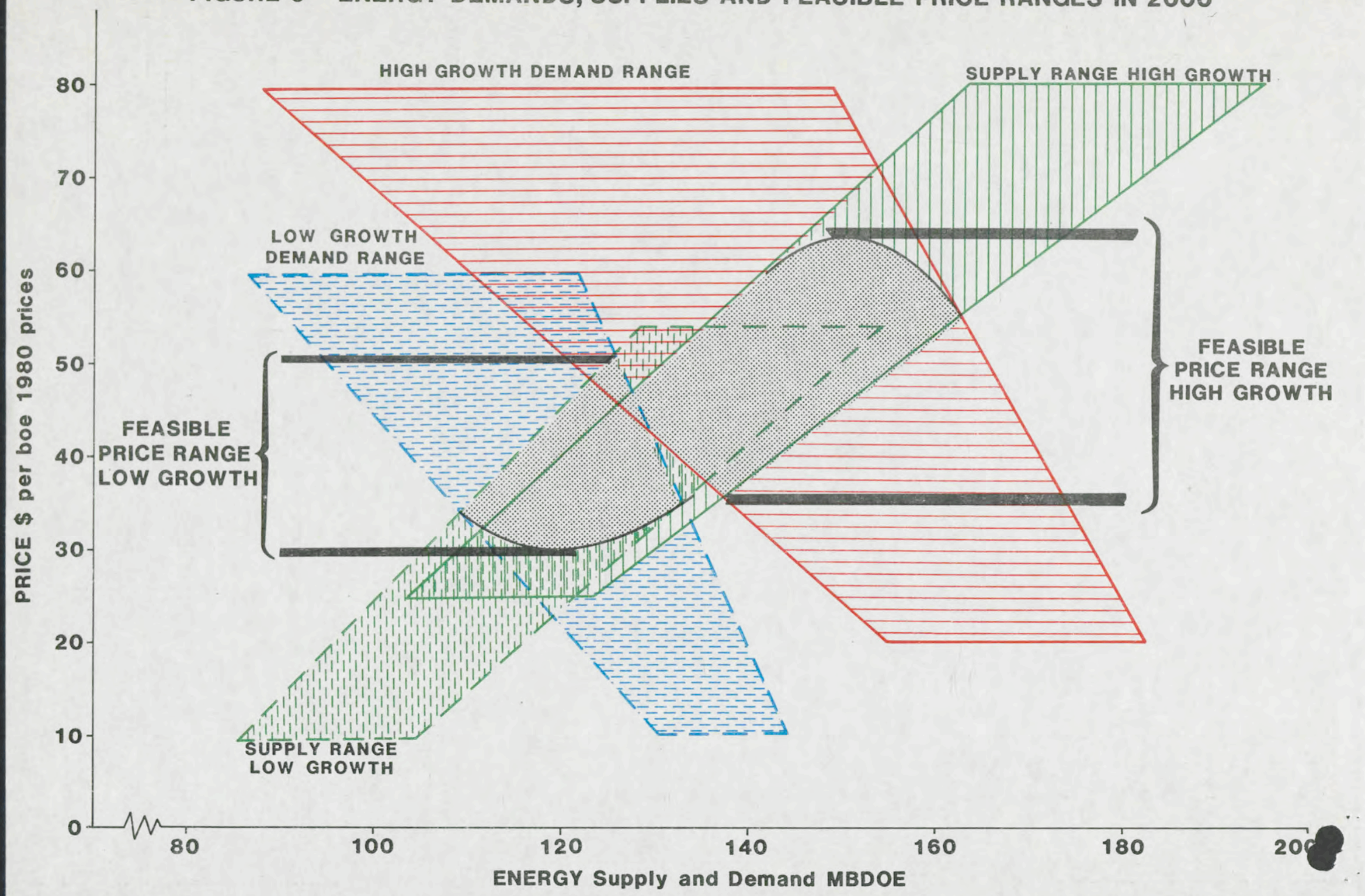


FIGURE J - ENERGY DEMANDS, SUPPLIES AND FEASIBLE PRICE RANGES IN 2000
HIGH GROWTH DEMAND RANGE
SUPPLY RANGE HIGH GROWTH
LOW GROWTH DEMAND RANGE
FEASIBLE PRICE RANGE HIGH GROWTH
FEASIBLE PRICE RANGE LOW GROWTH
SUPPLY RANGE LOW GROWTH
PRICE $ per boe 1980 prices
0
10
20
30
40
50
60
70
80
80
100
120
140
160
180
200
ENERGY Supply and Demand MBDOE

World Energy Balances

59. Table 8 below shows ex ante energy balances which would arise on particular combinations of demand, supply and price. Demand and supplies must finally reach broad balance so that the real oil price would rise whenever there was excess demand and fall whenever there was excess supply. The table is derived from the energy demand projections in Table 5 and the supply projections in Table 6. An additional higher price assumption (rising to $60 by 2000) has been introduced in Table 8 to show how supplies and demand on the high growth/low conservation assumptions might be balanced.

TABLE 8 ENERGY BALANCES (SUPPLY MINUS DEMAND) ON DIFFERENT ASSUMPTIONS

Excess supply = +
Excess demand = -

mbdoe

Oil Price	OPEC output	Low growth		High growth	
		1990	2000	1990	2000
Low		+16 to -3	+4 to -26	+3 to -19	-25 to -66
High	35	+33 to +10	+45 to +1	+23 to -5	+24 to -34
Highest		+37 to +13	+61 to +13	+27 to -2	+40 to -22
Low		+1 to -18	-6 to -36	-12 to -34	-35 to -76
High	20-25	+18 to -5	+35 to -9	+8 to -20	+14 to -44
Highest		+22 to -2	+51 to +3	+12 to -13	+30 to -12

60. On the highest price case tested (a price rising to $60 by 2000), the net energy balances show an excess of supply over demand in all except the most extreme combination of high growth with low supplies, low conservation, and OPEC output restrictions. On the lowest price case tested (a price falling to $25 by 1985 then held constant to 2010) the net energy balances show excess of demand over supply on all except the most extreme combinations of low growth, high conservation, high energy supplies and maximum OPEC output levels. These results suggest that the price range indicated by the low price case and the highest price case is broad enough to encompass most of the likely developments.

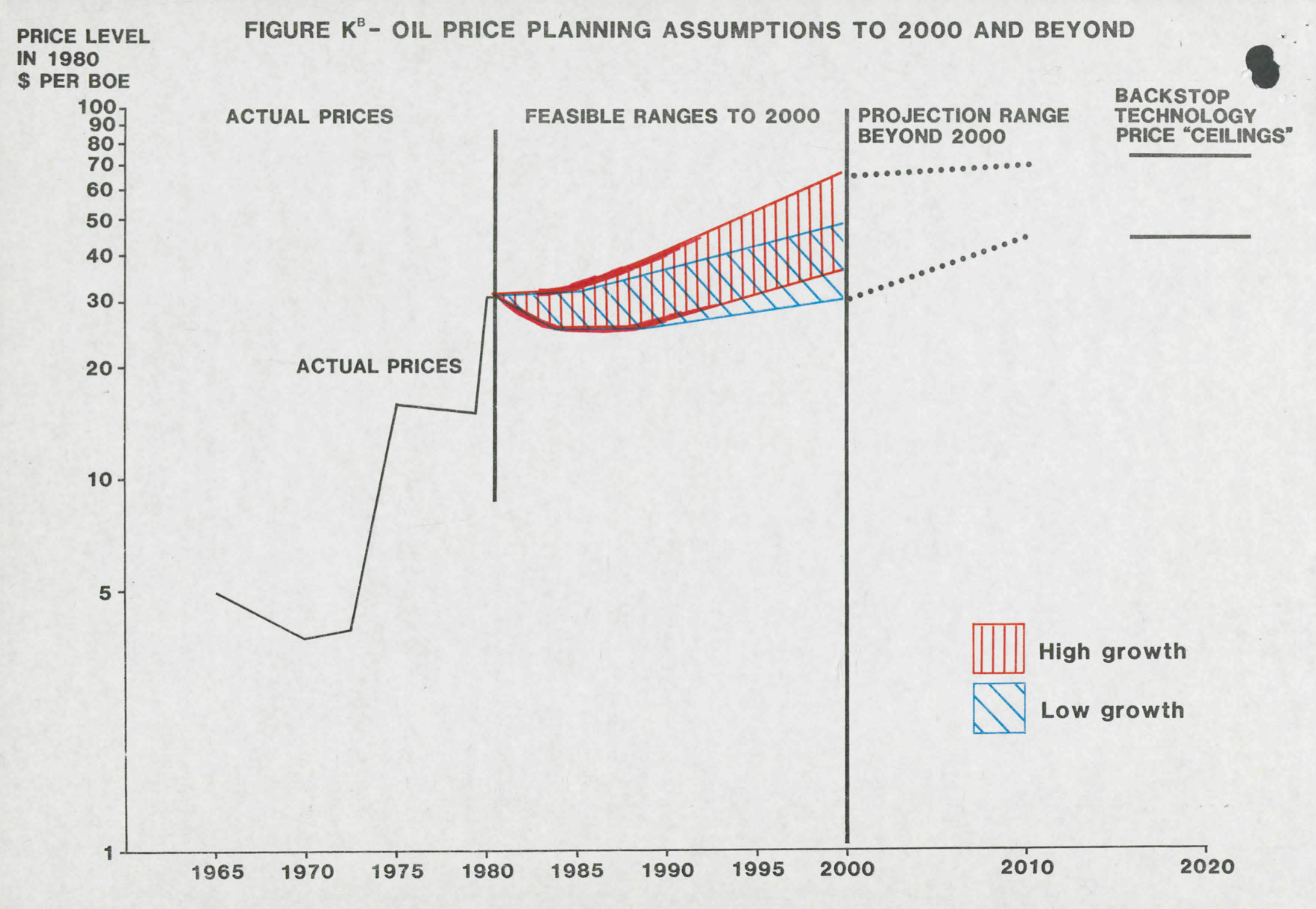
61. Figures I and J take the analysis further, setting out the balances of Table 8 and also our estimates of supply and demand classifications (indicated by the slopes). Figure I shows for 1990 and Figure J for 2000 (in green) the relationships between oil price and energy supply on optimistic and pessimistic range ends, previously shown in

Figure G. The red areas show the relationships between the oil price and energy demand on the high and low conservation assumptions for the high growth case, while the blue areas show the same for low growth. The intersection of the demand and supply areas indicates combinations of demand, supplies and prices which are feasible. At prices below those at the bottom of the feasible zone, demand for energy would exceed supply so that the price would rise. Conversely, at prices above the top of the feasible zone, supply would exceed demand, so that the price would fall.

62. Within these zones is a range of prices at which demand and supply could be in equilibrium on some combinations of growth, conservation, and supply optimism. Some of these combinations may be less likely; for example, high growth is less likely to be combined with pessimistic assumptions on each of the energy supplies and with low conservation. Similarly low growth is less likely to be combined with optimistic energy supplies and high conservation. For these reasons, the upper edges of the high growth intersection and the lower edges of the low growth intersection are ringed off leaving a feasible zone of price/output combinations all of which must be treated equally seriously.

63. The upper and lower price bounds set by these feasible zones are shown in Figure K. The price bands in Figure K give the planning assumptions for oil prices to the year 2000, and beyond, recommended by this study. At the bottom end, we do not think that a price below $25 could be sustainable for more than a few years and even on low growth assumptions combined with optimistic energy supplies, high conservation and OPEC producing at maximum capacity, we would then expect the price to climb back to at least $30 by 2000. At the top end, even with high growth combined with pessismistic energy supplies, low conservation and a restrictive OPEC output, we do not think that a price above $65 would be sustainable for more than a few years, in the period to 2000. But we think that the full range of prices between these two price paths is <u>feasible</u> and that prudent investment appraisals and energy planning exercises should test their results against both ends of the price path ranges which we indicate.

64. In the short term, the conservation effects of the 1970s price shocks, the supply increases consequent on those shocks, competition for market-share within OPEC and low economic growth could together drive the price below these price bands. But this would be temporary as it would sharply improve oil's competitiveness with other fuels and thus increase the demand for oil. We think that such short run possibilities are best ignored for the purposes of long term planning assumptions.


PRICE LEVEL
IN 1980
$ PER BOE
FIGURE K[B] - OIL PRICE PLANNING ASSUMPTIONS TO 2000 AND BEYOND
ACTUAL PRICES
FEASIBLE RANGES TO 2000
PROJECTION RANGE
BEYOND 2000
BACKSTOP
TECHNOLOGY
PRICE "CEILINGS"
100
90
80
70
60
50
40
30
20
10
5
1
ACTUAL PRICES
High growth
Low growth
1965
1970
1975
1980
1985
1990
1995
2000
2010
2020

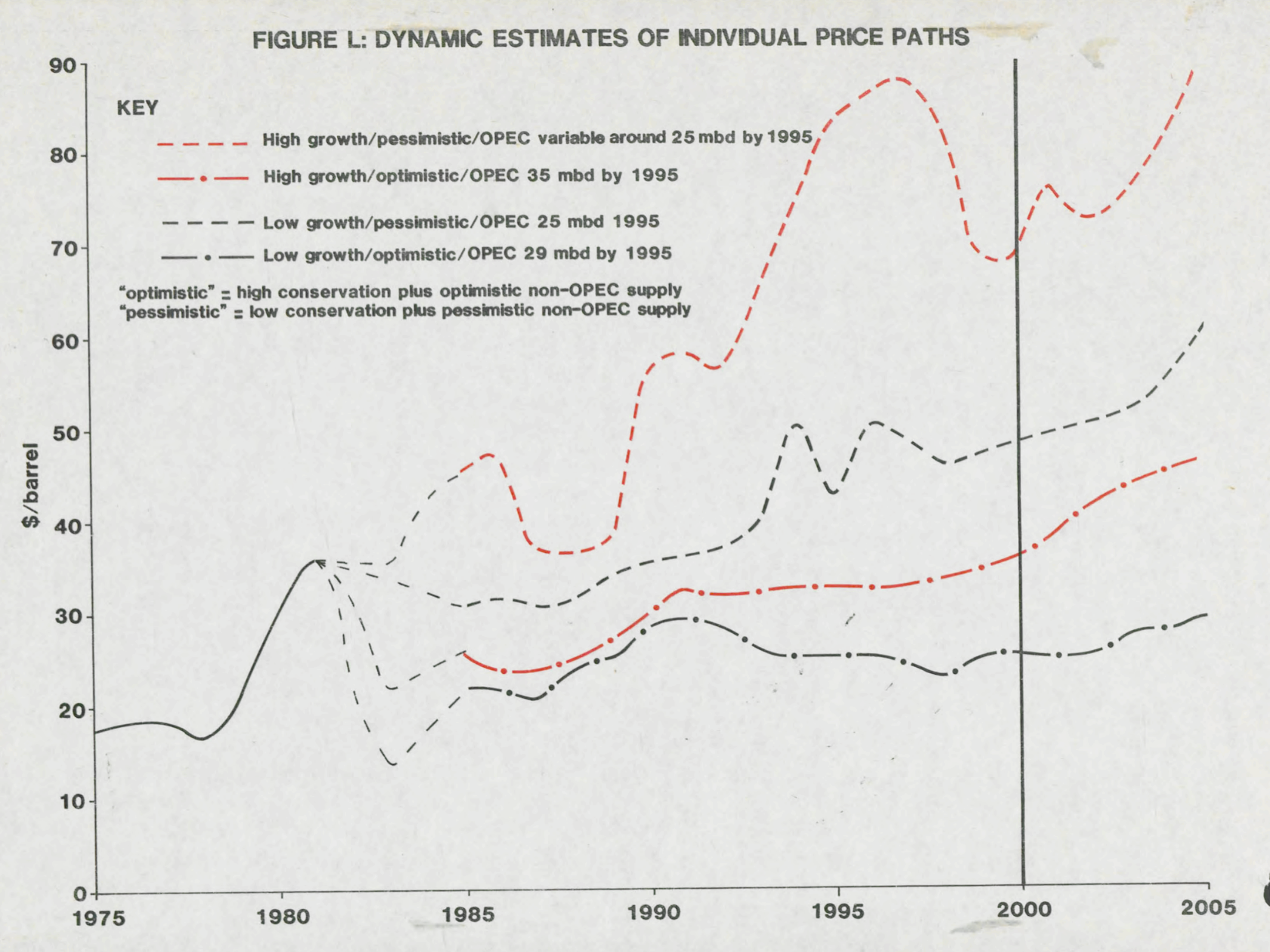


FIGURE L: DYNAMIC ESTIMATES OF INDIVIDUAL PRICE PATHS
KEY
High growth/pessimistic/OPEC variable around 25 mbd by 1995
High growth/optimistic/OPEC 35 mbd by 1995
Low growth/pessimistic/OPEC 25 mbd 1995
Low growth/optimistic/OPEC 29 mbd by 1995
"optimistic" = high conservation plus optimistic non-OPEC supply
"pessimistic" = low conservation plus pessimistic non-OPEC supply
$/barrel
0
10
20
30
40
50
60
70
80
90
1975
1980
1985
1990
1995
2000
2005

A

Dynamic estimation of individual price paths

65. The general methods outlined above assume that energy prices adjust smoothly from their present levels so that both supply and demand respond progressively. In practice energy prices are likely to move more abruptly and the path taken by prices during the 1980's may significantly influence the path of prices through the 1990's. We examined some of these effects in an alternative computer based model, in which the assumed price is allowed to adjust more abruptly on a year by year basis to clear any projected market imbalances (ie if excess demand appears in the projections, the price for that year rises until the excess demand broadly disappears). Figure L shows, by way of example, some of the price tracks which follow from underlying assumptions about economic growth, the rate of conservation, the level of non-OPEC energy supplies and the level of OPEC output. The upper line is on the combination of high growth with low conservation and low supplies which we earlier judged to be possible, but outside the range which we regarded as being realistically likely. Similarly, the lower line is an extreme combination of low growth, high conservation and high supplies which we also believe to be less probable. Between the upper and lower lines is a wedge within which a wide range of detailed price paths are possible of which just two are shown for illustration. These are not to be detailed projections; they simply illustrate the methods. The wedge between the upper and lower boundaries broadly supports the range of price assumptions which are given in Figure K.

66. This method has also been used to test the expected reaction of the price to a sudden disruption of supplies. Projected supplies in each case were reduced by 5 mbd in 1987 and 1988; the model suggests that the oil price in 1987 and 1988 could rise by \$15 in the low conservation cases and by about \$5 in the high conservation cases. However, the price in all cases would rapidly fall back to the range and would indeed lie below the undisturbed price path for the following 8 to 10 years. Even in the absence of major shocks, the actual price path could well be marked by a series of over - and under-shootings, as consumers and producers incorrectly perceive the future course of prices, act mistakenly and then in later years seek to correct their mistakes.

Surprises

67. We have considered how far our price bands might be affected by surprise developments. We have distinguished between major surprises, which could have long term consequences for the oil price, and surprises of a temporary nature which should not affect the long term price trend. We think that the chances of long term surprises causing reductions in supply (eg permanent loss of oil production capacity, lack of international agreement on gas transmission) are about the same as those of long term increases in supply (eg new major finds of fossil fuels, technological breakthroughs).

There could also be surprises on the demand side (eg arising from growth rates above or below those we have assumed). However, by their very nature, these surprise developments are difficult to take into account; to attempt to do so would risk widening the price ranges to the point where they would be unhelpful for users.

Prices Beyond 2000

68. Looking ahead to the next century, energy prices will be increasingly influenced by the availability of capital-intensive and non-fossil supplies - eg nuclear, renewables and unconventional oil. For some technologies, the potential contribution to world energy supply is limited by the extent of reserves (eg shale oil) or suitable sites (eg geothermal and hydro). For other technologies, particularly nuclear, the rate of growth is limited by the high capital requirements compared with total world investment.

69. No single technology will be able to meet all likely growth rates of energy demand; increasingly expensive energy sources will have to be used for higher levels of demand. If growth continues at the lower end of the range assumed in this exercise, then sufficient alternative supplies should be available at a cost below $60 per barrel of oil equivalent (boe). If growth continues at the top of the range, energy sources with costs over $60 per boe may have to be used. In principle it should be possible to undertake sufficient investment to expand these alternative supplies more or less as rapidly as any likely growth in demand; so a price beyond $70 looks unlikely to be sustained. If these alternatives are available in significant quantities in the first half of the next century, further increases in the real price of energy will be no more than any increases in the costs of supplying them. For this reason, we think that real price increases are likely to be constrained in this period.

Other Studies

70. The Appendix reviews the results of other recent studies of long term oil price prospects. Many of these indicate a price range similar to that in our own Study. Some of those which indicate a rather higher range reflect earlier work which could not have taken account of more recent market developments.

VIII CONCLUSIONS

71. The longer term impact of the large energy price increases of the 1970s remains unclear. In particular, we are not yet able to disentangle the short term effects and those of the recession on energy demand from the more permanent changes. Uncertainty as to the future course of energy prices has in this way been increased.

We have attempted to cope with this uncertainty by identifying a feasible range beyond which prices are unlikely to go, except perhaps temporarily, in response, for example to sudden supply disruptions.

72. Over the period to 2000, we see WOCA energy supplies increasing by between ½% and 2½% a year. The range is generated partly by the pace of technological development and new fuel finds, and partly by energy prices. Energy demand at constant prices is likely to grow at between ½% and 3% a year, depending on the rate of economic growth and the pace of energy conservation. The market price of energy will inevitably adjust to align the growth of energy demand and that of supply. This process yields a feasible zone for the oil price in 2000 of some $30-65 in 1980 prices. This is made up of two price bands: one relevant to a world of high economic growth and one relevant to a world of low economic growth. Beyond 2000, new energy supply developments seem likely to place a constraint on further, lasting price increases. By about 2030, a price range of $45-75 in 1980 prices seems feasible.

REVIEW OF OTHER RECENT STUDIES

1. It may be helpful to consider our projections and recommendations alongside other long term projections of world energy demand, supply and prices. Table 9 summarises some recent projections. The developments that prompted our review of energy prospects have led others to reconsider their projections, and we are still awaiting updated information from some of the major institutions. This makes comparison between projections particularly sensitive to the timing of the studies on which they are based. Generally, most of the new projections have revised downwards their previous views about economic growth, energy demand and prices, as we have done. Several of the major oil companies have become noticeably more reticent about their views than they were formerly.

2. Most of the studies make a single assumption about the rate of world economic growth, the most frequent one being 3½ per cent a year. This is at the highest end of our own range of growth assumptions (2¼ to 3½%) which is marginally wider than that used by the US National Energy Policy Plan.

3. Energy Demand in 2000 is projected by most of the studies as lying in the range 140 to 160 mbd. Our own high growth projections, which are most closely comparable, range from about 130 mbd in our high conservation case to about 160 mbd in our low conservation case. This indicates that we have moved slightly further than other studies in attributing larger effects on energy demand for conservation, though the others may well follow. Our low growth cases include a significantly lower energy demand range of 110 to 130 mbd.

4. Oil supply in 2000 is projected by most of the forecasters to lie in the range 50 to 65 mbd. OPEC output is projected in a fairly narrow range of 25-28 mbd, markedly below present installed capacity of 35 mbd. Our projections of oil supply include synthetic oils, and the top end of our range includes the possibility of OPEC producing in line with a sustained maximum capacity (although the latter possibility is not important in determining the feasible price range).

5. Supply projections for other fuels are also shown in Table 9. Detailed comparisons are not possible because in some studies, including ours, energy supplies are shown on initial working assumptions about price whilst in others they are shown on the basis of final price projections. Our two initial working assumptions lie below the price range which we finally recommend, and calculations on the basis of these price recommendations raise energy supplies as a whole by about 15% (though individual fuels are affected to different extents). For this reason our <u>ex post</u>

projections are broadly similar to the ranges projected by most of the other forecasting institutions, though the International Energy Agency seems to forecast rather more coal, gas and nuclear at their own assumptions for energy prices.

Oil Price Projections

6. The three oil companies which have been prepared to publish up to date projections foresee prices in the range $30 to $55 per barrel in 1980 prices. This broadly covers the lower 2/3 of the price range which we recommend, but it is marginally lower than the $35 to $65 range which we recommend on our high growth assumptions. The Chase Manhattan Bank see a range of $30 to $76, though they focus rather more on their central estimate of $53. The Institute of Energy Economics (Japan) assume similar economic growth ranges to our study and give a range of price projections of $40 to $60. This is similar to though narrower than the range which we recommend.

7. Mr Taher of Saudi Arabia's Petromin points to a somewhat higher price trend, though beyond 1990 that trend is stated to be more uncertain and more dependent on the degree of cooperation or confrontation between producers and consumers. Similarly, the Energy Modelling Forum (a collection of academic forecasts) project a price range of $40 to $90 a barrel. This was obtained by running a constant set of economic assumptions through 9 econometric models of world energy (though most of these models were developed and their relationships chosen two or three years ago). The International Energy Agency (in their recent World Energy Outlook) do not produce price projections but give energy demand and supply projections on the basis of initial working assumptions for price. By 2000, these price assumptions are clearly in disequilibrium, with an excess energy demand of 9-21 mbd. The US Department of Energy use methods which are the most similar to the mixture of econometric estimates, judgements and supply assumptions which we use. Their latest projections (August 1982) for the oil price indicate a range for 2000 of about $40 to $65 on a price-basis comparable to that used in our own Study.

TABLE 9: PROJECTIONS OF WORLD ENERGY IN 2000

PROJECTIONS	Date of Publication	Real Oil Price in 2000 ($ bl)	WOCA Primary Energy Demand (MBDOE)	WOCA Economic Growth Rate (1980-2000 % pa)	OIL PRODUCTION WOCA MBD	OIL PRODUCTION OPEC MBD	WOCA Coal Production MBDOE	WOCA Gas Production MBDOE	WOCA Nuclear Output MBDOE
THIS STUDY	Oct '82	30-65	110-164	2.3-3.6	44-70*	25-35	26-35*	13-26*	6-15*
CHASE MANHATTAN BANK	Sept '81	53 (30-76)	149	3.4	50	24(?)	38	26	13
CHEVRON	June '82	30-55	143	3.5	52	26	37	24	12
CONOCO	Jan '82	45-55	152	3.4	60	28	39	27	14
ENERGY MODELLING FORUM	Feb '82	70 (42-90)	152-161	3.6	49.65	28-34			
INSTITUTE OF ENERGY ECONOMICS, JAPAN	May '82	50 (42-60)	140-155	2.5-3.0	51-62	23-30	37	27	16
INTERNATIONAL ENERGY AGENCY**	Oct '82	28-45**	154-179	3.1-3.7	48-55	24-28	37-45	26-28	***
A H TAHER, PETROMIN	Early '82	[55-98]ø	140	3.1	41	21	47	27	18
TEXACO	July '81	40 (37-45)	150	'below historic trend'	60	34	38	27	13
US NATIONAL ENERGY POLICY PLAN	July '81	58 (41-79)	140	3 (2.4-3.4)	48 (42-54)	26 (21-43)	37 (28-43)	29 (23-36)	16 (10-17)
"	Aug '82	52 (44-61)	137 (132-143)	3 (2.6-3.5)	50 (48-54)	26 (23-29)	34	23	11

* These are estimated supplies on starting price assumptions. In the recommended price range supplies are higher

** The IEA projection is <u>not</u> a forecast. With an energy deficit of 9-12 mbdoe active policy intervention is required to offset further price rises.

*** The IEA project OECD Nuclear capacity at 12-13 mbdoe. Our OECD projection is 7-11 mbdoe.

ø An extrapolation of his 3 to 6% pa range to 1990. Hazarding a guess beyond 1990 is unreasonable given the uncertainty. Prices are lower in a scenario of producer-consumer co-operation but higher in a confrontation scenario.

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Energy SCW

cc: LG Energy

10 DOWNING STREET

THE PRIME MINISTER

22 March 1982

Dear Mr. Wilson

Thank you for your letter of 25 February on the question of world oil prices.

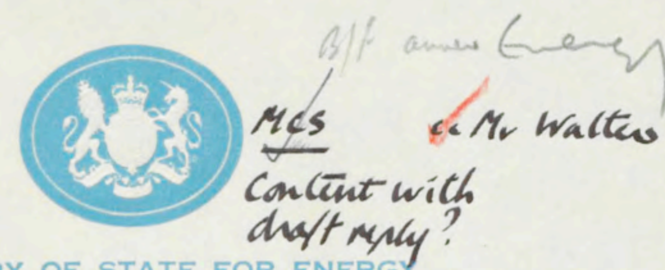
Your letter assumes that a fall in world oil prices will be damaging to the UK economy and that we share an interest with other oil producers in trying to maintain prices by cutting production and exports. My own view, on the contrary, is that the Western Industrial countries - and indeed the non-oil developing countries as well - will all benefit from lower oil prices through the consequent reduction in inflation and increase in real incomes. The favourable effects on the UK of these factors seems likely well to outweigh any direct loss of national income through a reduction in the value of UK net oil exports.

An agreement among all oil producers to reduce production by an equal proportion would certainly be against the UK's interests, since the effect on export volume would more than cancel out the benefit of higher prices (a 10% reduction in production would imply something like a halving of UK net oil exports); the benefits would all accrue to those few countries whose production is several times their domestic consumption. A reduction in all oil producers' net exports by an equal proportion would not be open to the same objection (although, in my view, such a cartel operation would be objectionable on general grounds); but, in any event, the UK share of world net oil exports is so small as to make our participation in such an arrangement practically irrelevant; the problem is essentially one for OPEC to tackle.

Yours sincerely

Margaret Thatcher

Gordon Wilson, Esq., M.P.



SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

MCS
cc Mr Walters
Content with draft reply?
MAP 16/3.

MAP
Yes: I have taken account of Alan Walters' points.

Mike Pattison Esq
10 Downing Street
London
SW1

16 March 1982

MCS 17/3
Type as amended for PM sig
cc I.G.
MAP

Dear Mike,

Thank you for your letter of 26 February enclosing a letter from Mr Gordon Wilson MP to the Prime Minister. Mr Wilson asked my Secretary of State a closely related question in the House on 8 March (attached).

I attach a self-explanatory draft reply.

Yours ever,

JULIAN WEST
Private Secretary

DRAFT LETTER TO MR GORDON WILSON MP

My own view on the contrary is that

Thank you for your letter of 25 February on the question of world oil prices.

Your letter assumes that a fall in world oil prices will be damaging to the UK economy and that we share an interest with other oil producers in trying to maintain prices by cutting production and exports. The Western Industrial countries - and indeed the non-oil developing countries as well - will all benefit from lower oil prices through the consequent reduction in inflation and increase in real incomes. The favourable effects on the UK of these factors seems likely well to outweigh any direct loss of national income through a reduction in the value of UK net oil exports.

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(although, in my view, ~~it would be object~~ such a cartel operation would be objectionable on general grounds): but, in any event,

Mr. Merlyn Rees: Will the Minister confirm that gas prices have increased by 100 per cent because of the Government's actions and that the standing charge has increased by 300 per cent? As there has been a decision to increase the charge, why can there not be a decision to change it in other ways?

Mr. Mellor: Removing the differential charge for the first 52 therms of gas meant that when the Labour Government left office the standing charge was £6·37 a quarter, so the effect is not markedly different.

Oil Sales

3. **Mr. Greville Janner** asked the Secretary of State for Energy, further to his reply to the hon. Member for Southend, East (Mr. Taylor) on 8 February, *Official Report,* column 250, how much oil was exported to Israel in the most recent period for which figures are available.

The Minister of State, Department of Energy (Mr. Hamish Gray): None, Sir.

Mr. Janner: Will the Minister reconsider the unhappy policy of discrimination that has led to that sad answer? In the interests of free trade, should we not nowsell our oil to a democratic customer anxious to buy it?

Mr. Gray: The policy is not aimed against any country but is in favour of European Community and International Energy Agency countries with whom we have a special energy relationship. We should ask licencees to recognise those relationships. There are many other friendly countries to whom we do not export oil because they are not members of those alliances.

Mr. Marlow: As the Israeli war machine is the greatest threat to Middle East stability, would it not be a little absurd for Her Majesty's Government to provide it with fuel with which it could threaten world peace?

Mr. Gray: My hon. Friend's point hardly relates directly to the question.

British National Oil Corporation

4. **Dr. J. Dickson Mabon** asked the Secretary of State for Energy how many barrels of oil produced daily from the oilfields in the United Kingdom sector of the continental shelf the British National Oil Corporation handles as a trader.

The Secretary of State for Energy (Mr. Nigel Lawson): In 1981 it was 1,037,000 barrels per day.

Dr. Mabon: As that is such a profoundly overwhelming proportion of the total, does it not suggest that BNOC should remain an integrated trading, explotation and production company?

Mr. Lawson: I fail to see the logic of the right hon. Gentleman's question. The figure points to the strength that BNOC, after the flotation of Britoil, will have in the world's oil markets.

Mr. Gordon Wilson: Does the Secretary of State not recognise that the drop in world oil prices will affect the trading arm of BNOC, as it will the Government directly? Is it not time for the Government to act in concert with OPEC to cut production to maintain the price level and to save in Scotland jobs that will be lost if North Sea development does not take place?

Mr. Lawson: The fall in oil prices will have a much more positive effect on jobs in the Western world, including the United Kingdom and Scotland, than the policy that the hon. Gentleman would like us to pursue.

Mr. Archie Hamilton: Does the question asked by the right hon. Member for Greenock and Port Glasgow (Dr. Mabon) not demonstrate the fact that the SDP has great difficulty in making up its mind whether it is for or against nationalisation?

Mr. Lawson: My hon. Friend is absolutely right. The SDP has great difficulty in deciding where it stands on everything and anything.

Mr. Rowlands: Is the Secretary of State aware that BNOC is facing its greatest crisis since it was created and that the fall in oil prices has created a major problem for the trading arm, which could lose large sums of money? Does he agree that now is not the time to smash up the corporation, as it would destroy the morale of the State trading arm personnel? Will the right hon. Gentleman at least consider postponing that part of the Oil and Gas (Enterprise) Bill for at least 12 months to give the corporation a chance to weather the storm?

Mr. Lawson: No, Sir. I am confident that BNOC will remain fully capable of dealing with world economic developments and developments in the oil market as they occur.

Space Policy

Mr. Michael Marshall asked the Secretary of State for Energy with what aspects of Her Majesty's Government's space policy his Department is currently concerned.

The Under-Secretary of State for Energy (Mr. John Moore): Clearly I am concerned to ensure that my Department is aware of developments in space technology that are of interest to energy related issues.

Mr. Marshall: With the growing increase of loading for commercial satellite projects in this country and the scientific satellite development through the European Space Agency, in which Britain plays a leading part, does my hon. Friend agree that the time is now overdue for us to take a wider look at those issues? Will he carefully consider the opportunities in the remote sensing programme and for solar energy through space developments.

Mr. Moore: Knowing my hon. Friend's extensive knowledge and experience, I shall maintain my Department's watching brief.

Diesel Fuel

6. **Dr. Mawhinney** asked the Secretary of State for Energy how much diesel fuel was produced in the United Kingdom in the last year for which figures are available.

Mr. Gray: My Department's estimate is 5·5 million tonnes in 1981.

Dr. Mawhinney: Does my hon. Friend agree that the diesel engine industry is a strategic industry and that firms like Perkins in my constituency should not be exposed to unfair competition, from whatever source?

16 MAR 1982

GORDON WILSON MP

3 March 1982

ALAN WALTERS

PRIME MINISTER

await D/En draft. due 12/3

PROPOSALS BY GORDON WILSON FOR BRITIAN TO JOIN OPEC, LETTER OF 25 FEBRUARY

1. I agree with Mr. Wilson's judgement that the world price of oil is likely to collapse to between $25 and $28 per barrel. The remainder of his letter, however, contains muddled arguments, logical fallacies, and statements which are clearly discredited by the evidence of the last ten years. However, I will only deal with the main points in this note.

2. His first statement is that the decline in oil prices will lead to freezing of oil development pending stabilisation of the market. But what determines investment and development is the prospect of after-tax profit for the oil companies. This will be calculated over the amortisation period of the assets, probably ten years or so for the average oil investment. The oil companies will take into account their estimate of the pattern of oil prices which they expect over the next ten years. Reductions in the price of oil which are seen to be transitory will have no discernible effect on investment. Furthermore, if the oil price were artificially held up by some restriction of output, then it would be known that later there would be an increase in the supply of oil which would bring the price down below the level which would otherwise have ruled. Furthermore, restrictions on output brought about by some depletion policy would necessarily reduce the overall profit of the oil companies and so give rise to lower investment, ceteris paribus. In short, Mr. Wilson's policy would be fairly certain to lower investment and development in the North Sea.

3. Mr. Wilson believes that we should make common cause with OPEC and agree to cut production in order to stabilise prices. He admits the North Sea output is a mere drop in the bucket, but somehow feels that if we agree to cut production, all other important producers will agree to cut also. The evidence of the past few years, however, is that even the Saudis, under the most auspicious circumstances, with their enormous market power have failed to control the Cartel. The high price of OPEC oil has induced a vast expansion of non-OPEC production, and given rise to the existing cuts in prices. Moreover, anything the West do in order to curtail the production of oil will simply open the gates for other producers to fill the production gap.

/These countries

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These countries are not merely developing countries such as Indonesia and Nigeria, anxious to pay for their development programmes, but also countries of the Eastern bloc.

4. In short, there is no way in which we could conceivably support the price of oil. But even if we could, we should not do so. Cheaper oil will give rise to widespread benefits in the Western industrialised countries which can only be favourable to Britain as well. These benefits will far outweigh the small loss in our small net export balance of oil.

5. Mr. Wilson suggests that we have a "realistic depletion policy" for oil. I think our policy should be to have a <u>profitable</u> depletion policy for oil. This will be achieved if we allow the private sector to recover oil at a rate which maximises their own profits and our revenue over the years. Mr. Wilson might reflect that if we had introduced depletion policy when we came into office, we would have reduced the production of oil during the years 1979-81 and so foregone the very large benefits which flowed from the extraordinarily high price of oil during that period. This would have been an inexcusable waste of the most valuable national asset. In 1979/80 we should have been importing expensive foreign oil in order to keep our own oil in the ground. Mr. Wilson believes that we can out-guess the market. I doubt it. Governments have been singularly inept when they have played the markets. There is no reason to believe that we could do any better.

3 March 1982

AW

ALAN WALTERS

CONFIDENTIAL

FILE

Alan Walters

To see & return pl.

MCS 3/3

ds

12/3

10 DOWNING STREET

From the Private Secretary

26 February 1982

I enclose a copy of a letter to the Prime Minister from Mr. Gordon Wilson M.P., about Government action on the crude oil price. I should be grateful for a draft reply for the Prime Minister's signature by 12 March.

I am sending copies of this letter to John Holmes (Foreign and Commonwealth Office), Jill Rutter (HM Treasury), Muir Russell (Scottish Office) and David Wright (Cabinet Office).

M. A. PATTISON

Julian West, Esq.,
Department of Energy.

ds

26 February 1982

I am writing on behalf of the Prime Minister to thank you for your letter of 25 February. I will place it before her and a reply will be sent to you as soon as possible.

M A PATTISON

Gordon Wilson, Esq., M.P.

2

10 DOWNING STREET

PRIME MINISTER

Gordon Wilson writes arguing that the Government must make common cause with other oil producing countries to stabilise the market. He has copied his letter to OPEC Governments. We will let you have a draft reply.

MAP

26 February 1982

Please show this letter to the Chancellor and the Energy Secretary; Also - should like Alan Walters advice.

cc Ian Gow
Press Office

Gordon Wilson M.P.

HOUSE OF COMMONS
LONDON SWIA OAA

25th February 1982

The Prime Minister
The Rt. Hon. Margaret Thatcher M.P.,
10, Downing St.,
Whitehall
London SW1A

Dear Prime Minister,

Unless speedy action is taken, the world price of oil is in danger of collapse to between $25 and $28 per barrel. Already, the slide in oil prices has placed in jeopardy the chances of even a moderate reflation of the economy. Not only is it the case that oil taxation revenue will drop sharply but the decline in oil prices will also lead to the freezing of oil development pending stabilisation of the market. This will have drastic consequences for offshore and onshore oil related oil employment in Scotland.

The Government cannot duck this issue. The international oil market is spiralling downwards and, while this may impact beneficially on the Western world for a short time, it will lead inevitably to diminishing exploration and development. Such actions are vital if new reserves of petroleum and gas are to be found and won to avoid future shortages.

For Scotland there is not the same urgency over revenue. An oil tax return of £5 to £6 billion is more than adequate in a Scottish context. However, the budgetary prospects for the UK as a whole are more damaging and it serves neither Scotland nor the UK to be caught up in a low-price regime.
Oil from the North Sea is high-cost oil and it is obvious that internationally cheap oil, induced by over-production, will not be to our advantage. Indeed, the over-production of crude oil from the North Sea and Mexico has partly led to the glut and to the fiscal embarrassments now facing the UK and other oil producers.

This being so, the Government must make common cause with the other oil producing countries to stabilise the market and the price regime even if, in the interests of Western economies as a whole, it would not wish to participate in a "hike" of oil prices beyond the limits previously fixed.
The Saudi production cuts will not, of themselves, halt the slide. I understand that OPEC will probably call an emergency meeting shortly to discuss production cuts by oil producers. I hope you will request an invitation from OPEC to send an official observer and be prepared, on hearing the report, to consider, along with the oil companies who are also suffering financially from the price collapse, agreeing to cut production.

Any cuts the UK may make in the North Sea will be minimal in world terms but collectively, taken with reductions made by the OPEC countries, they will have an impact.

Stabilisation of the world price for oil will restore confidence, halt the decline in oil revenues and maintain oil exploration and development. It should be made clear that the cuts in production are temporary to cope with the emergency. In the medium and longer term there is a need for a realistic oil depletion policy which will be more sophisticated and which will relate to policy over development as well as production.

This matter is of concern to all oil producing countries and therefore I am copying this letter to all members of OPEC.

Yours sincerely,

Gordon Wilson

GORDON WILSON M.P.

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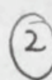
Prime Minister



Foreign and Commonwealth Office

MCS 21/10

London SW1A 2AH

20 October 1981

From The Minister of State

Richard Luce MP

Dear Nigel,

NORTH SEA OIL PRICING POLICY

Thank you for copying to Peter Carrington your letter of 6 October to Geoffrey Howe about the results of the review by officials of our North Sea oil pricing policy.

I agree that the report demonstrates that the existing arrangements have served us well, and in particular that we were right to adjust our price rather than the volume of production in a slack market. I also agree that we shall want to move back to the top end of the range if the market becomes tight and that we could justify this as being consistent with not intervening in a slack market. However, we shall need to judge the precise speed and extent of the price rise in the light of circumstances at the time. As you recognise in your letter, we need to avoid being seen as overtly aggressive, and we could probably wish to avoid being the market leader with our oil at the very top of the price scale, just as we did before.

On this basis I am happy to accept the report by officials enclosed with your letter, and that you should put the conclusions and recommendations to the Chairman of BNOC.

I am sending copies of this to the recipients of yours.

Richard

The Rt Hon Nigel Lawson MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London SW1P 4QJ

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22 OCT 1981

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Prime Minister

MCS 19/10

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

19 October 1981

The Rt. Hon. Nigel Lawson MP
Secretary of State for Energy

Dear Nigel

NORTH SEA OIL PRICING POLICY

Thank you for your letter of 6 October about the report of the Working Group of officials on North Sea Oil Pricing Policy.

I agree with the report's recommendations (paragraph 6.3) and with your suggestion that these should now be formally conveyed to the Chairman of BNOC. Though I recognise that in current market conditions an increase in UKCS prices is not in prospect, I hope that at the same time you will remind the Chairman of the point, reflected in your letter, and emphasised by Robin Ibbs in his of 8 October, that directly tight markets reappear, it will be important to get North Sea prices up as quickly as is possible consistent with avoiding serious international objection. The importance of prompt action here is underlined by the tax revenue at stake. As paragraph 1.3 of the report points out, even relatively small changes in the price of oil have an important absolute effect on Government revenues: for example, an additional $1 per barrel on UKCS crude increases the Government's take by £240m.

I am sending copies of this letter to the Prime Minister, the Foreign Secretary, Sir Robert Armstrong and Mr Ibbs.

GEOFFREY HOWE

Energy   cc A Walters   A Duguid

NBPM ypt

CABINET OFFICE

Central Policy Review Staff

70 Whitehall, London SW1A 2AS   Telephone 01-233 7765

From: J. R. Ibbs

Qa 05696

8 October 1981

CONFIDENTIAL

Dear Chancellor,

North Sea Oil Pricing Policy

The Secretary of State for Energy has sent me a copy of his letter to you dated 6 October.

I support the conclusions in his letter together with those in the report by officials. In particular I agree with the Secretary of State that when tight markets reappear it will be important to get prices up as quickly as is possible without giving rise to serious international objections.

I am sending a copy of this letter to the Prime Minister, the Foreign Secretary, the Secretary of State for Energy and Sir Robert Armstrong.

yours sincerely,

J R Ibbs

The Rt Hon Sir Geoffrey Howe QC MP
HM TREASURY
S W 1

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8 OCT 1981

CONFIDENTIAL

cc Mr Walters
Mr Duguid

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

01 211 6402

NBPM ygt.

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

6 October 1981

Dear Geoffrey

NORTH SEA OIL PRICING POLICY

In your minute of 6 February to the Prime Minister you suggested that officials should review our North Sea pricing policy in order to check that we were not missing any legitimate and sensible opportunities for securing the maximum revenue from UKCS crude oil sales. David Howell, in his letter of 16 February, agreed to this proposal and as a result a working group of officials, under a Department of Energy chairman, was set up. The first phase of the group's work dealt with the circumstances of a tight market. Following the reduction of North Sea prices in June efforts were extended to cover slack market conditions, as you requested in your letter of 5 June.

I enclose a copy of the group's report which has been agreed by our officials. I endorse the general conclusion that as regards the balance between fiscal and diplomatic benefits existing arrangements have served reasonably well. I believe that in the recent softening market our general approach of lowering price in order to retain the volume of sales has proved clearly preferable, in terms of maximising current Exchequer revenues, to that of the African producers. They have attempted to hold up prices for as long as possible and as a result have experienced a precipitous decline in sales and revenues.

When tight markets reappear it would be right to allow UKCS prices to return quickly to close to the top end of the range of world prices though, as always, it would be important to avoid being seen to be overtly aggressive thus attracting diplomatic opprobium.

If you are content with the conclusions and recommendations set out in the report (paragraphs 6.1 to 6.3) I propose to convey these formally to the Chairman of BNOC.

I am sending copies of this letter and the report to the Prime Minister, the Foreign Secretary, Sir Robert Armstrong and Mr Ibbs.

Yours ever
Nigel

NIGEL LAWSON

6 OCT 1981

NSOPP(81)13

NORTH SEA OIL PRICING POLICY

A Report by Officials

INTRODUCTION

1.1 In his minute of 6 February to the Prime Minister, the Chancellor of the Exchequer proposed that officials should take a fresh look at North Sea oil pricing policy to ensure that legitimate and sensible opportunities for securing the maximum value for UKCS crude oil were not being missed. Accordingly, a Working Party of officials drawn from the Department of Energy, Treasury, Foreign and Commonwealth Office, Inland Revenue and the Central Policy Review Staff was set up under a Department of Energy chairman to examine the issues and report to Ministers. The British National Oil Corporation (BNOC) were also represented at a number of the meetings of the Working Party.

1.2 In June, when market pressures forced BNOC to reduce prices, the Chancellor registered concern at the apparent asymmetry whereby the UK tended to follow others in a rising market while being among the first to move down when prices were falling. The Working Party have accordingly examined UKCS crude pricing in both rising and falling markets.

1.3 Revenues from the North Sea were about £3.8 billion in 1980/81 and on current assumptions are forecast to rise to some £6 billion (at constant prices) by 1983/84. Even relatively small changes in the price of oil have an important absolute effect on Government revenues. For instance, an additional $1 per barrel on UKCS crude (about 3 per cent) in 1981 would have increased the Government take by £240m, of which £180m would have fallen in the current fiscal year. (A 3 per cent fall in the value of the pound has the same effect).

1.4 In preparing this report the Working Party examined how UKCS prices responded to the market, the price relationship between different crude oils, the international implications of the level of North Sea prices, possible avenues for maximising prices in strong markets and ways of minimising reductions in weak markets.

SETTING UKCS CRUDE PRICES: THE CENTRAL ROLE OF BNOC

2.1 When the first UKCS oil fields came on stream in 1975 world oil supplies were plentiful and spot market disposals commonly took place at below term contract prices. UKCS prices were set by the oil companies in negotiation with each other, and the Government's main concern was to ensure that producers disposed of their crude oil at prices which reflected the full term contract value in order to maximise the tax yield. Petroleum Revenue Tax was accordingly levied either on the actual selling price in respect of third party sales, or, in the case of crude oil retained within companies, on a value which was assessed retrospectively in the light of prevailing world market prices.

2.2 The decision taken was thus in effect to reject a "Government Selling Price" approach. UKCS prices were left to follow the market and the main policy emphasis was placed on securing a proper tax take. The market price approach was also a basic feature of the subsequent arrangements whereby BNOC acquires oil under the participation agreements. The Petroleum and Submarine Pipelines Act 1975 established BNOC as the principal agent of majority state participation but the oil was left in the ownership of the producing companies, subject to the contractual terms of negotiated participation agreements. No power was taken to control the prices at which the companies dispose of their equity oil.

2.3 Prior to 1978 BNOC handled no oil. Since then UKCS oil production has rapidly built up; BNOC has exercised its options under the participation agreements to take up to 51 per cent of producing companies' oil after royalty; and the Government has exercised its discretionary right to take royalty in kind for which BNOC has acted as selling agent. In consequence more than half of the UK's oil production of about 1.8 million barrels per day now passes through BNOC's trading account. This gives the Corporation a central role in determining UKCS prices and indeed arm's length term sales by other producers are normally concluded at BNOC prices. As long as the BNOC price can be seen to follow the market and provided there is no evidence of a significant proportion of UKCS oil being sold at other prices, the Oil Taxation Office will normally agree valuations of the 35 per cent of crude transferred between affiliated companies broadly in line with BNOC's negotiated prices. Thus BNOC's prices have effectively become de facto market prices for UKCS crudes.

2.4 The predominant trading position of BNOC inevitably leads to an assumption by some companies and foreign Governments that BNOC, acting on Government instructions, effectively sets quasi-official UKCS crude oil prices. There are however practical reasons why this could not be so under existing arrangements. The terms of the participation agreements give producing companies a contractual right to market prices for the oil acquired by BNOC. These prices have to be agreed prior to the beginning of each quarter. If agreement on prices cannot be reached with BNOC, there is provision for expert determination which is binding on both sides. To avoid a financial loss BNOC must agree in turn with its customers selling prices which reflect the costs of acquisition. BNOC is therefore constrained in its price negotiations on the one hand by producers who will normally seek the full market price to which they have a contractual entitlement, and on the other by consumers who are not normally prepared to pay more than the commercial

value of the crude. BNOC's room for manoeuvre on prices is thus extremely limited. Moreover, in this process of buying and selling BNOC has to deal with some 40 different companies, and to bring the price negotiations to a timely conclusion the Corporation must be able to take quick decisions based on its own commercial judgement.

2.5 BNOC is thus in practice a price taker rather than a price setter. This was clearly shown in June of this year (see paragraphs 3.2ff). Nevertheless the Corporation consults with Government before making price changes. This provides Government with the opportunity to give such guidance as seems desirable and practicable. Current arrangements are set out in Annex A.

THE DEVELOPMENT OF UKCS CRUDE OIL PRICES

3.1 From the beginning of BNOC's trading activities until June 1981 UKCS prices were closely related to those of the more aggressive OPEC producers. This arose largely because the quality of UKCS crude is very similar to the quality of oil sold by those producers (the Africans) and in a firm market where all output is being sold similar crudes should sell for similar prices. It can be argued that BNOC prices, whilst being close to the top end of the range, were nonetheless a little below what might have been achieved, particularly over the past year. To the extent that this occured it was not through any inherent weakness of BNOC as a trader but reflected a perceived diplomatic need for UKCS prices not to outstrip those of all the OPEC producers. A detailed analysis of UKCS prices prior to June 1981 is given in Annex B.

3.2 During the summer of 1980 the oil market moved towards a glut; stocks were high and supply exceeded demand. The product market was characterised by prices which covered the cost of Saudi crude but not the cost of African and North Sea crudes which were some $2 to $3/b more expensive (after allowing for differences in quality). By September 1980 pressure was mounting for a price reduction but the advent of the Gulf war removed the glut and deferred market pressure which did not build up again until the spring of 1981. By then the Saudi price, which again determined the price of products in the market, was more than $4/b below all other prices and refiners could not afford to continue taking other crudes. From quite early in the year the Africans, especially the Nigerians, found they could not sell all their output. By June the Africans had collectively lost nearly 50 per cent of their sales. Meanwhile pressure was mounting on BNOC. The option to reduce at short notice the volume of oil taken was not available to the Corporation because of its term contractual commitments to lift the oil (see paragraph 5.6). Because BNOC's customers had a contractual right to phase out from or suspend contracts if prices could not be agreed, BNOC had little option but to reduce prices to a level at which the oil could be sold. This level is roughly equivalent to the Saudi price and thus, for the moment at least, the link with African prices is broken.

3.3 The recent price reduction has allowed BNOC to continue to dispose of all their available crude, albeit with a loss of some 11 per cent in total revenues, whereas African revenues have dropped by up to 60 per cent because of the lost volume. Thus at least as regards current revenue the UK policy of responding to market forces by price reduction rather than volume has been vindicated.

3.4 Following the failure of the Geneva OPEC meeting to agree on a new unified price structure and production cut-backs, we may expect a continuation of the present weak market for some time to come. For 1982, the Saudis have said they want a price freeze and they have the production capacity to back up that policy. But in the medium term we can expect OPEC to seek a steady increase in prices, in line with their Long Term Strategy.

ECONOMIC AND FISCAL CONSIDERATIONS

4.1 Higher world oil price levels have a number of adverse consequences for the OECD economies generally, including lower growth of real disposable incomes, terms of trade loss, and diversion of investment to alternative sources of energy. Erratic upward oil price movements particularly damage world trade and output, add to inflation and prolong the problems of OPEC financial surpluses. Although the UK would be better placed than other OECD countries (we would not experience a terms of trade loss) higher world oil prices would tend to lessen our competitiveness via the exchange rate effect and would reduce demand for UK exports as a result of depressed world trade. Thus any general increase in the world price of oil would not be in our best interests and it would be undesirable on economic grounds alone for there to be any change to UKCS prices which might trigger an increase in world prices by encouraging the OPEC hawks.

4.2 On the other hand, an increase in UKCS prices which had no effect on world oil prices would tend to be beneficial as a result of higher tax revenues (exchange rate and consequential effects seem likely to be negligible overall). For instance an extra 25 cents a barrel would yield some £45m to the Exchequer in the first year and as much as £100m by the fourth year if the increase were to be sustained.

4.3 In general then, it is in the UK's interest to achieve the highest prices for UKCS crude oil for a given set of world oil prices. But it would not be in our interest if any action by the UK triggered a general increase in world prices. Conversely, it might in principle seem desirable to act in respect of North Sea prices in any way which would help reduce world prices. In practice, however, the relatively small volume of UKCS crude, together with the constraints on BNOC (see section 2), tend largely to preclude such an approach. Thus the range of possible actions is effectively restricted to those that might modestly improve North Sea prices relative to other world crude prices.

SCOPE FOR INCREASING UKCS PRICES RELATIVE TO OTHER PRICES

Tight Markets

5.1 There is no commercial reason why BNOC should not seek top term prices in tight market conditions. The Government have however accepted that to seek the very top prices, as opposed to a price marginally lower, is to risk the leap frogging process in which the more aggressive African producers would seek to outstrip UK prices; this could trigger off a world price spiral which would not be in the national interest. These are arguments which France, Germany and the US urge upon us and are similar to those we ourselves have deployed when we have pressed OPEC countries to be moderate over prices.

5.2 Thus in 1979 and early 1980 the Government took the view that it would be internationally unacceptable for UKCS prices to lead the market which was rapidly moving upwards. BNOC were therefore urged to raise their prices only after all three African producers had first done so. On two

occasions the Africans failed to move in unison and the North Sea producers pressed BNOC hard for increased prices, which the Government regarded as untimely. The Government therefore asked the companies to hold back. In particular, the producers were pressed to forgo a $4/barrel increase throughout January 1980 in the national interest. The producers complained that this was an expensive gesture; by the end of the month the strain was showing and it is doubtful whether the line could have been held much longer. But by then Nigeria had moved into line with the other two African producers and the Government felt able to allow BNOC to raise its prices in line with world levels. Because BNOC had sold its oil at the lower price level failure to have held down the buying price in January 1980 would have cost them some $12 million. The revenue lost to the Exchequer through holding down prices amounted to some £80 m.

5.3 There is perhaps some scope for the Government to stand back a little more than hitherto, thereby allowing BNOC to move ahead rather earlier and to reach slightly higher price levels (perhaps 25 cents/barrel). Indeed, this enhanced freedom to respond to the market was implicit in the decision to stand back as BNOC moved prices down in June this year. Generally, BNOC might be encouraged to achieve the highest prices that the market will bear, while accepting the principle that we should not be seen to lead the market and thereby precipitate further increases in world prices, and subject to the agreed consultation procedure with the Government (Annex A). The balance between these two conflicting elements at any particular time is necessarily a matter for fine judgement. Certainly, an overtly aggressive pricing policy would attract strong international criticism, particularly from the US and those EC countries which have ports on the North Sea, since these are the principle overseas recipients of UKCS oil. We must also expect that an aggressive policy would be used by many OPEC producers to justify their own stance; they would point to the inconsistency between that policy

and past lobbying prior to OPEC meetings when the UK has pressed for price moderation.

5.4 Apart from the question of the general stance on pricing a number of particular approaches aimed at obtaining rather higher prices for UKCS oil in tight markets have also been considered, including the use of premia on top of term prices, spot sales, forward sales, c.i.f. sales and processing deals. These are discussed in Annex C. Our conclusion is that while certain of these are practicable the benefit to be gained would be relatively small.

Weak Markets

5.5 In June 1981 BNOC were forced to cut their prices by $4.25 in response to strong pressure from their customers, against a background of an overall surplus of supply over demand. BNOC had to move before other producers largely because they were not able to reduce their acquisitions of oil quickly. The African producers, in contrast, chose to maintain prices while shutting in production as their customers walked away from expiring contracts. As previously noted, the immediate loss of revenue has been much greater with this strategy. Very recently, however, the Nigerians have decided to cut their prices by $4 a barrel in order to try to recover sales, and there are suggestions that the North African producers are resorting to surreptitious discounting of one kind or another.

5.6 There are two major differences between the position in the North Sea and in the African countries producing comparable crudes, to whose prices UKCS prices have traditionally been linked. First, the African governments are able to cut production quickly to reflect a fall in demand at the prevailing Official Selling Price. In contrast, BNOC has virtually no powers to cut back its short-term availability (see paragraph 5.8), nor does the Government, except through the cumbersome production

cuts machinery in the context of implementing a depletion policy. Second, the Government attaches high priority to the maximisation of Exchequer revenues and little if any importance to keeping up UKCS prices, per se. The reverse appears to be true in the case of the African governments, despite, for instance, the pressing need of the Nigerians for revenues.

5.7 In principle it would be possible for the Government to take steps, most probably involving new statutory powers, to enable crude production to be varied at short notice to reflect market circumstances, thereby helping UKCS prices to be maintained. But this would involve a major change of approach towards the production and disposal of UKCS crude as well as a short-term loss of revenue. There would seem to be little merit in such a departure and it is not considered further. We have considered, however, whether under different conditions the reduction in UKCS prices last June might have been decreased or delayed, given the broad pattern of existing arrangements.

5.8 One possibility was that had BNOC been able to allow customers taking some 200,000 b/d (20 per cent of BNOC's total availability, 40 per cent of freely traded crude) to walk away from their third quarter contracts a smaller reduction in UKCS prices would have been attainable. However, the scope for short term reductions in availability of oil to BNOC are very limited. BNOC's equity oil availability depends on agreement with its partners in the various fields; participation volumes can only be varied with periods of notice of six months or more; and similarly for royalty oil which BNOC sell as agent for the Government. The producers would be unlikely to agree to shortening substantially these periods of notice. Temporary storage of oil by BNOC would in principle be possible, as a means for dealing with reluctant customers, but there would be very real risks that such a move would fail to hold the price and the loss of revenue in selling later at a lower price would be compounded by the cost of

storage. Storage is not therefore recommended as an instrument for influencing price though there may be logistic or commercial reasons for BNOC to store cargoes for short periods.

5.9 Although, as noted, short term reductions in the availability of oil to BNOC are not feasible, it would be possible to reduce longer term availability by declining to take participation oil or by reducing (or eliminating) the amount of royalty collected in kind. From the point of view of pricing we believe that course to be unwise (though there could be other reasons for so doing which lie outside the scope of this report). Major reductions in BNOC's availability would leave the price of UKCS oil exposed to unconstrained market forces. It seems very likely that in the absence of BNOC's steadying influence prices would have moved downwards earlier and perhaps to a greater extent in the Spring and Summer of 1981, given the pressures from loss-making refiners and the depressed spot market for N Sea crudes. The closest parallel is the US market where price reductions started in the Spring and were continuing in a downward spiral of several cuts for each crude, as late as July. Conversely, when markets tighten BNOC's position as the major trader enables the Government to have some influence on events if it so chooses. The absence of BNOC would tend to result in more volatile movements in UKCS prices in both directions.

5.10 A second apparent weakness in BNOC's position during the price negotiations in June was the relative ease with which their customers would have been able to leave crude oil with the Corporation had not agreement been reached on price. Overall, the UK's position is comparatively protected compared with many OPEC countries because of the producers' equity stakes and the various agreements for "saleback" of participation or royalty oil to the producers; the producers would generally be reluctant, or find it difficult in practice, to reduce these volumes (though BP, as sole licensee of Forties, has been able to cut production

temporarily). The problem lies at the margin with the 30 per cent of UKCS output that is sold at arms length by BNOC. The contracts, which are of course subject to normal commercial negotiation, must be appropriate in both slack and tight markets. It seems likely in general that contractual improvements made with a view to future weak markets would tend to lose BNOC revenue in tight markets. Nevertheless, there may be particular contractual terms capable of improvement. For instance, BNOC's forward oil sale contracts allow customers to suspend lifting for a full quarter at minimal notice in the event of disagreement on price, rather than the usual gradual phase out of purchases (this concession was allowed in return for unusually favourable payment terms). BNOC intend to avoid such terms in the future.

5.11 A third possible approach designed to improve prices in a slack market would be intervention by the Government. Pressure by Government last June might have had some effect on those UK-based refiners with long term saleback arrangements though little could have been expected in the case of BNOC's overseas customers at a time when each barrel of North Sea crude refined represented a loss to them of up to $6. In general Government pressure is unlikely to be useful other than at the margin. Companies have recently demonstrated vis-à-vis OPEC producers that there is a point when commercial imperatives override government pressure. Although oil companies have an interest in secure supplies they are not interested in security at a price they cannot afford. North Sea producers are unlikely to accept low prices for extended periods nor would refiners accept high prices. Government pressure should not therefore be seen as anything more than a device for securing some modest advantage, particularly for relatively short periods of time and perhaps in the extent of the adjustment.

CONCLUSIONS

6.1 The crucial element in the determination of UKCS crude oil prices is BNOC's negotiation of a price which is acceptable to both its customers and the producers. Because of the participation agreements this price must reflect the world market price. Any attempt by BNOC or the Government to force the price outside a narrow negotiating range would give rise to a real risk that either producers would demand expert determination of the price (with the possibility of a less favourable outcome) or that customers might refuse to take at least part of their contractual volumes. Nevertheless, because of the scale of its trading operation BNOC is able to bring some steadying influence into the market which would not be available if the companies simply traded with one another. In particular, BNOC can, to a limited extent, help underpin prices in a weakening market and provide the Government with the option of limited intervention in the interests of moderation in rising markets.

6.2 In terms of maximising Exchequer revenues and minimising diplomatic repercussions existing arrangements have served reasonably well. Over the period from early 1978 to the end of 1979 UKCS prices achieved on average somewhat more than their full commercial worth, as judged against the African producers' prices. Most recently, although BNOC was forced to cut its prices when the Africans chose not to do so (losing up to 60 per cent of sales volume instead), the general strategy of taking the market on price rather than on volume has proved to be clearly preferable. Although the Government must expect to be subject to international pressure to moderate UKCS price increases in a rising market the fact that it did not intervene when prices were falling could be used to argue for a similar lack of intervention when the market turns around. One might thereby justify taking UKCS crude prices quickly back

to the top of the range as prices firm, in contrast to the situation in the 1979/80 rising market where Government pressure resulted in more moderate increases, both in terms of the speed of response and the level eventually attained.

6.3 We conclude that scope for action to secure higher prices for UKCS crude oil, against a background of a given level of world oil prices, is relatively limited. We recommend that:

(i) the present arrangements whereby BNOC in effect seek to maximise the price obtained for UKCS crude oil by following the world market in negotiating prices should be endorsed;

(ii) consistent with (i) above BNOC should aim to get the best price for UKCS oil in both firm and weak markets unless specifically requested by the Government to moderate their stance, following the agreed consultation procedure;

(iii) the Government should continue to consider the merits of intervention on a case by case basis, recognising in particular that intervention in the interests of price moderation may result in an appreciable revenue loss to the Exchequer;

(iv) the Corporation should be encouraged to keep the form of their selling contracts under continuous review with the aim of minimising price reductions in a falling market while not inhibiting subsequent price increases as the market hardens.

ANNEX A

CONSULTATIONS BETWEEN BNOC AND GOVERNMENT IN THE EVENT OF PROPOSED CHANGES IN NORTH SEA PRICES

In September 1980 BNOC agreed to the following procedure but subject to the reservation that if BNOC was likely to be exposed to risk as a result of Government policy, it would be necessary for the Board to consider the position in advance and if necessary to invite the SoS to issue a direction

(i) The Government will define to BNOC its broad pricing policy and BNOC will continue to be responsible for seeking price settlements in line with that policy. At present that policy involves securing full term market price for UKCS crudes but on a basis which demonstrates that UKCS prices are following and not leading the market;

(ii) BNOC will inform the Department of Energy as soon as it perceives any change in market prices and the extent to which this is likely to put pressure on UK prices;

(iii) Department of Energy will inform other interested Departments. Ministers will be consulted if there appear to be special reasons for attempting to restrain normal market forces;

(iv) in the absence of any decision within Government to seek to intervene, consequent on the consideration at (iii) above, BNOC will be free to determine the appropriate prices for the crudes it sells in accordance with the Government's pricing policy and with shifts in the market;

(v) BNOC will inform the Department of Energy as soon as possible, and in any case not less than a full working day, before implementing the precise changes at (iv) above in order to provide an opportunity for the Department and the FCO to make available any appropriate presentational guidance.

THE DEVELOPMENT OF UKCS CRUDE OIL PRICES

1. The value of crude oil. Crude oils have a wide variety of qualities. The two most important are density and sulphur content. The less dense an oil, the greater the fraction of the more valuable light products, such as gasoline, which may be extracted whilst low sulphur content increases the value of the fuel products, particularly that of heavy fuel oil. Light low sulphur crude (ie 'sweet') oils therefore have a higher commercial value than heavier high sulphur crudes. The common light sweet crudes traded internationally are from Nigeria, Libya, Algeria and the North Sea; thus in a clearing market the price of North Sea oil is closely related to the selling price of African crudes and these are in turn higher than the prices for other crudes.

2. However it is not possible to put a precise commercial value on a particular crude oil. The mix of products which may be obtained depends upon the complexity of the refinery process used, the value of the individual products depends upon the particular market into which the products are sold and transportation costs depend upon location of both the source of the oil and the refinery. Taking all these factors into account the value of a particular crude oil to different refiners may vary on a worldwide basis by as much as several dollars per barrel. However, it is the worth of a crude oil to the marginal purchaser which determines its price and hence crude oils are usually traded internationally at a single term contract price for a particular quality and thus it is important for refiners to be able to make some assessment of relative value of oils. This is particularly true where oil companies exchange crudes and a cash adjustment is needed to compensate for quality differences. For practical reasons calculations are usually performed with a particular market in mind and assuming only simply refining.

3. The main market for UKCS crude is North West Europe and in assessing the price which UKCS crude should command the oil industry tends to make comparisons against the natural competitors ie African crudes. Starting with an official African price it is possible to calculate the approximate value which a refiner would place on a UKCS crude if making a choice on commercial criteria only. This value can then be compared with the actual selling price of the UK crude and the difference is a measure of pricing below or above the market level as set by comparable crudes.

4. Performance of UKCS. The graph at figure 1 sets out the difference between the price of UK Forties and its average commercial worth calculated from prices charged by the Africans. Whilst the precise figures may be a matter of some debate both for the reasons set out in paragraph 2 and because even the prices for different African crudes are not equivalent in terms of commercial value, the graph is illustrative of the general trends from the end of 1978 to the second quarter of 1981 by which time the market was no longer clearing all willing production and individual producers were facing a choice of taking the market either on price or volume but not both.

5. For practically the whole period from October 1978 to November 1979, whilst market prices were changing markedly and frequently in the wake of the Iranian revolution the Forties price was above its calculated value, on average by some 90 cents per barrel. This may be one of the

reasons why international criticism of UK prices gathered momentum in the second half of 1979. Relative value calculations are not performed only by oil companies; they are closely watched by the oil press and more importantly by the US Department of Energy.

6. Figure 1 clearly shows the effects of the deliberate policy of price moderation introduced in early 1980. With the backing of strong Government intervention to urge producers not to press their case for an increase, BNOC held back a UK increase after two of the three African producers had increased their prices. When UK prices did move in February 1980 they did so by 21 cents less than the African increases. In May BNOC continued to act with moderation and forewent a further 50 cents increase which could have been justified on the grounds that it would have only matched increases by the Africans. These acts of moderation should have reduced the apparently high pricing levels of 1979 back to the calculated value but during 1980 there were changes both in transportation costs and in theprice structure of the product market. These effects increased the relative commercial worth of UKCS crude compared with African crudes. A third component in the final sum was the imposition of premia largely by Algeria. For the first part of 1980 some two thirds of Algerian customers were surcharged by $5/b. This surcharge was dropped in September 1980. The net result has been that between the end of 1979 and May 1981 the calculated value of UKCS crude relative to African has moved from a clear lead to a position where the value appears to lag by some 90 cents per barrel.

7. But by this time the market had moved into surplus and the higher priced producers became subject to intense pressure for a price reduction. BNOC responded in mid June with a decrease of $4.25/b. The Africans held their prices but were forced to reduce output by over 50%.

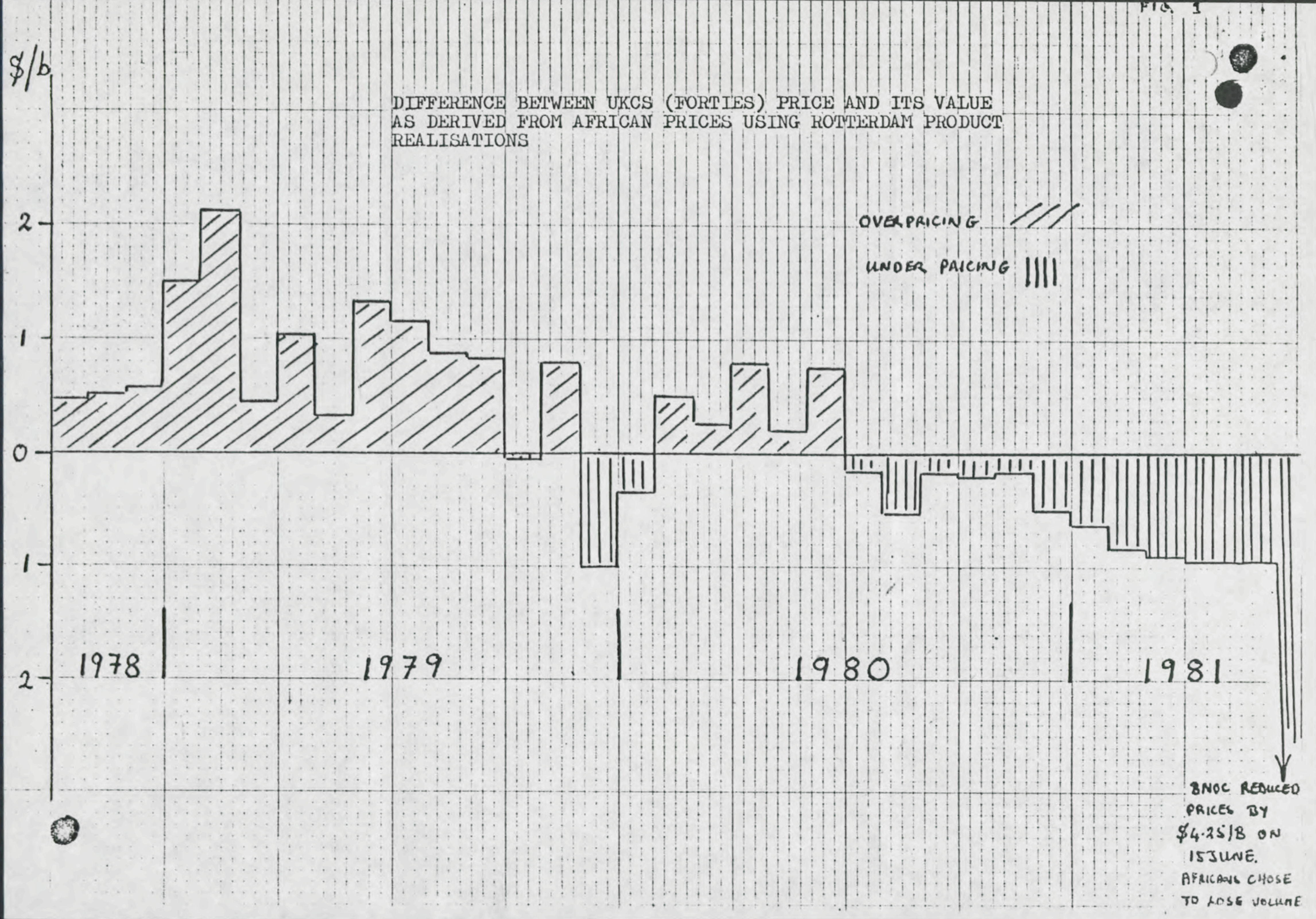
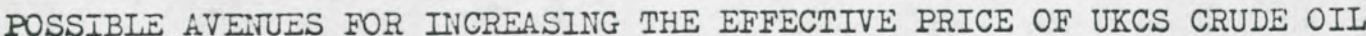


FIG. 1
$/b
DIFFERENCE BETWEEN UKCS (FORTIES) PRICE AND ITS VALUE
AS DERIVED FROM AFRICAN PRICES USING ROTTERDAM PRODUCT
REALISATIONS
OVERPRICING
UNDER PRICING
2
1
0
1
2
1978
1979
1980
1981
BNOC REDUCED
PRICES BY
$4.25/B ON
15 JUNE.
AFRICANS CHOSE
TO LOSE VOLUME



POSSIBLE AVENUES FOR INCREASING THE EFFECTIVE PRICE OF UKCS CRUDE OIL

1. The working group considered how crude oil is sold and examined ways in which exchequer revenues might be enhanced when markets are tight through direct or indirect means. In principle possibilities fall into two classes

(i) direct price increases on term sales either through the actual term price or through premia. These would provide benefits to the exchequer largely through taxation although there would be a modest contribution through equity crude. The scope for increased prices on premia is extremely limited because of the market price provision in the participation agreements. Spot market sales also fall in this class although real benefits can only be secured when markets are very tight and there would be strong pressure from our international partners to reduce spot trading;

(ii) benefits secured by BNOC through special trading arrangements limited to selected customers. The possibilities considered include forward sales, and two minor commercial opportunities which BNOC are already exploring (a price inclusive of transportation costs for delivery to US customers and having part of the crude availability processed so that full value added revenues may be secured). Under BNOC's present financial arrangements the benefits would acrue directly to the exchequer. When BNOC's financing arrangements are brought into line with those of other nationalised industries the benefits would, because of BNOC's high continuing investment programme which makes the Corporation a net borrower for some time to come, in effect secure a reduction in the PSBR.

2. Term prices. Annex B concluded that in some respects North Sea prices have been a little below the commercial value for light sweet crudes, (until the glut in mid 1981). The state of the market is unlikely to permit any unilateral increase by BNOC in the near future although they should be able to match any increase by Saudi Arabia. But even in past tight markets an aggressive pricing policy would have allowed UKCS prices to have advanced by, on average, a modest amount - perhaps some 25 cents/barrel or so.

3. Premia. A premium is a special payment over and above market price, generally in recognition of some benefit such as security of supply. In tight market conditions a number of OPEC countries have been able to collect premia; but events in the first half of 1981, particularly in Kuwait, have shown that when the market softens customers refuse contracts which bear premium particularly if market realisations from the sale of products are insufficient to cover even the official selling price of the crude.

But there is an additional problem in the UK. If BNOC were able to demand premia from some customers, producers would be able to claim that the market price BNOC paid for participation crude should be similarly increased. (There has already been on instance of an expert,

demanded by a company in conflict with BNOC, taking account of the nominal premium associated with forward sales in order to decide on a market price for UKCS crude; it must be expected that other experts would be likely to include any future premia). In effect this would finally lead to the UK price moving up to encompass the premia and the final outcome would be no different to a straight increase in the term price and hence open to the same international objections.

4. Spot sales. For several years prior to 1979 spot prices had not varied marketly from term prices and had in general been marginally lower. The Iranian revolution resulted in spot prices rising rapidly in 1979 at one point exceeding term prices by $14/b. Only in the summer of 1980 did spot prices fall back below term prices. This was short lived, spot prices rising above term prices following the outbreak of the Gulf war. They have since fallen and now stand at some $5/b or more below term prices for African crudes. There are thus great risks in moving into the spot market. Although the benefits are high in tight markets, so too are the losses in slack markets.

5. Forward Sales. BNOC have for the last two years sold limited quantities of oil on the basis of pre-payment. There is no benefit to BNOC but there is a benefit to Government. These payments, received earlier than for normal sales, go to the Exchequer via the National Oil Account; the early payment results in a saving on interest charges since the PSBR is temporarily reduced below the level which would have been necessary without the prepayments. The cost to the companies depends upon the particular arrangements but has varied from 50 cents per barrel to some $2 per barrel depending upon the details of the contract. Where companies finance the pre-payment by borrowing this can be offset against Corporation Tax; but this tax loss would not be entirely lost to the exchequer, in so far as the borrowing is in the UK since there will be additional tax take from the lending banks. At worst half the interest benefit which accrues to Government initially might be lost; but realistically the loss is likely to be considerably smaller. In all, the financial benefit to Government from early payment has probably been in the region of £5 to £10 million for each year of the scheme. Once the financial structure of BNOC is reorganised along the lines of other nationalised industries any interest saving would accrue to BNOC, whilst the tax loss would be borne by the exchequer. Nevertheless the overall benefit should still be seen in the PSBR. In order to put the forward payment scheme in place BNOC had to commit some 150,000 barrels per day of their oil. The current state of the oil market may make it impossible for BNOC to negotiate new forward sales contracts without providing some tangible benefits for the companies.

6. Other commercial measures. From time to time opportunities arise for BNOC to increase the revenue from part of their oil sales. Two particular methods are worth noting:

(i) the terms of sale to US customers have been changed from fob (normal sale at production terminal) to cif (sale on a delivered basis). Because BNOC would in total have much larger volumes to move across the

Atlantic than individual customers there should be a saving on transport costs; that might be up to 30 cents per barrel and would accrue to the Corporation;

(ii) processing deals. It might be expected that the sale of refined products should provide greater revenue than the sale of crude oil. At present product prices are depressed and the assumption does not hold, but over an extended period of time it should be true. BNOC is currently looking at the possibility of hiring refinery capacity to turn part of its crude availability into products and hence obtain the full added value. This course would require the consent of the Secretary of State.

6 OCT 1987

File

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Energy

10 DOWNING STREET

From the Private Secretary 12 June 1981

North Sea Oil Prices

The Prime Minister has seen your Secretary of State's letter of 10 June. She has commented as follows:

"I agree with BNOC. Further, we should not be resistant to their dropping their prices".

I am sending a copy of this letter to John Wiggins (HM Treasury), Stephen Gomersall (Lord Privy Seal's Office), and David Wright (Cabinet Office).

J. P. LANKESTER

CS

Julian West, Esq.,
Department of Energy.

CONFIDENTIAL

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
TELEPHONE: 01-211 3000
01-211-6402

Prime Minister

It has now been agreed that BNOC should be allowed to negotiate a $4-5 price reduction.

TL 12/6

Good MT

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

12 June 1981

Dear Geoffrey

NORTH SEA OIL PRICES

I explained in my letter of 10 June the possible courses of action in response to the failure of BNOC to find any takers for UKCS oil at $2/barrel below the present price. Nigel Lawson and I had a useful discussion on Thursday morning and that evening I saw Sir David Steel at his request. He explained that the combination of higher North Sea prices, a high rate of tax on the Forties field and severe downstream competition was leading to serious losses for BP. The question of the relationship between price and output for Forties naturally arose. BP indicated that at a price of about $35/b (corresponding to a cut of $4) they would wish to produce in the region of 350,000 b/d in the third quarter. At $34/b they would expect to reach 400,000 b/d.

Our officials subsequently agreed that in terms of Government revenues there was little to choose between a price reduction of $4 and one of $5, allowing for the likely effect on Forties production. In the circumstances I have authorised BNOC to open negotiations on Monday in the expectation that they will be able to settle with their suppliers and customers at a price $4-5 below present levels, preferably nearer $4.

BNOC intend to brief selected journalists in the course of Monday. For our part, we are able to maintain our stance that the Government do not intervene and that UKCS prices properly reflect the market position.

I am sending copies of this letter to the Prime Minister, the Lord Privy Seal and Sir Robert Armstrong.

Yours ever

David

D A R HOWELL

11 JUN 1981

2

Prime Minister

BNOC are now proposing to drop their prices by $4-5 rather $2 already agreed.

I agree with BNOC. Further, we should not be resistant to dropping prices. MT 10/6

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
TELEPHONE: 01-211 3000
01-211 6402

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1A 0AA

10 June 1981

Dear Chancellor,

NORTH SEA OIL PRICES

Philip Shelbourne, the Chairman of BNOC, came in today to bring me up to date with developments, following the Corporation's proposal of a $2/barrel price reduction on UKCS crude prices. Their customers have responded uniformly that this is inadequate; a $5 reduction was the suggestion generally made. A cut of this magnitude would bring UKCS prices down somewhat below the level, on a quality adjusted basis, consistent with the Saudi $32 'marker'. But a $4 reduction would appear to line us up more nearly with a price consistent with the Saudi level, and BNOC believe that their customers - particularly BP, Shell and Esso, - are seriously set on forcing UKCS prices down this far. The benefits to them would be a lower tax threshold, diminution of downstream losses and the chance of shaking the upper tier of the OPEC price structure.

BNOC see themselves as being in a weak negotiating postion. Their major customers could walk away from contracts as from 1 July, drawing stocks for a month or so. In the meantime BNOC would have to unload exceptional quantities of oil on the spot market at great financial sacrifice. If that market could not absorb such quantities production cut backs would need to be invoked, again at a serious cost to BNOC.

BNOC have put it to me that there are two options open. First, the Government could intervene with the three major companies to encourage them to accept the proposed $2 reduction, mentioning as an inducement possible loss of Government goodwill connected, for instance, with saleback arrangements, disposal of royalty oil and production consents. They accept that the likely success of such an exercise is uncertain, in terms of the impact on the finally agreed price.

The second option would be to allow BNOC a free hand. In this case

they judge that we shall end up with an overall reduction of around $4-5/barrel.

There are clearly disadvantages in intervening. We would be departing from our customary arms-length stance. We would tend to undermine BNOC's future position as a trader. And we would attract the criticism - both domestic and international - that we had intervened to hold up prices contrary to the momentum of market forces and would expose ourselves to future pressure to hold them down by intervention. Against this, there would be adverse implications for Government revenues and perhaps for the value of sterling.

On timing, BNOC need to tie up their third quarter sales by the end of next week, given the nature of contractual commitments. They judge that if there was to be Government intervention with the companies it would need to be made by this Friday to have an impact. We need therefore to make up our minds quickly. Our officials have already been in touch but I think we need ourselves to discuss this urgently.

I am sending copies of this letter to the Prime Minister, the Lord Privy Seal and Sir Robert Armstrong.

Yours sincerely,

B. D. Ward

pp. D A R HOWELL
(Approved by the Secretary of State and signed in his absence)

10 JUN 1981

Agreed WR 5/6

Energy 7

PRIME MINISTER

BNOC Prices

I believe Mike told you that BNOC were proposing to reduce their selling price of oil because of the world over-supply situation and the weakening of oil prices generally. They have now formally asked for authority to reduce their prices by $2 per barrel. Without such a reduction, they say that they could find themselves with 100,000 barrels a day and possibly more on their hands, which could only be disposed of at a significant loss on the spot market. Spot prices are currently some $6 per barrel below term prices. The Africans (to whose prices North Sea oil is of course closely linked) have not so far reduced their prices formally. They have cut back production instead - Nigeria by about 30%. But there are reports now coming in that Nigeria is offering a $2 per barrel reduction.

The Department of Energy go along with BNOC's proposal. So does the Chancellor.

Mr. Howell is seeing the BNOC Chairman at 1200. Can I say that you are content?

T P Lankester

5 June 1981

CONFIDENTIAL

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
TELEPHONE: 01-211 3000
211 6402

Prime Minister

The Chancellor mentioned this to you.

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

5 June 1981

Dear Geoffrey

BP-FORTIES

Thank you for your letter of today's date in which you accept that BNOC may negotiate a $2 a barrel reduction in the price of UKCS crude. You should be aware that Sir David Steel rang this lunchtime to inform me that as from mid-day today he had reduced production from Forties to 350,000b/d. I explained to him that BNOC would be negotiating on the basis of a $2 a barrel reduction in the price of UKCS crude for the next quarter. Sir David noted the point but suggested that in the absence of a price reduction of at least $4 a barrel the decision would stand for the time being. However, he did assure me that BP would give no publicity to this decision.

BP's present consent for production from Forties calls for a minimum production of 430,000 b/d for the current quarter. Thus, if they maintain production at 350,000 b/d from today they will soon be in breach of that consent. However, we have no formal sanction against such a reduction short of revoking BP's licence which we could hardly contemplate. I will keep you in touch with developments in the oil market following BP's action and the response to BNOC's pricing negotiations.

I am copying this letter to the Prime Minister, the Lord Privy Seal and Sir Robert Armstrong.

Yours ever

David

D A R HOWELL

5 JUN 1981

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

5 June 1981

The Rt Hon David Howell MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1P 4QJ

Dear Secretary of State,

UKCS OIL PRICES

Thank you for your letter of 3 June in which you seek agreement to informing BNOC that they go ahead with their proposed reduction of $2 a barrel in UKCS oil prices third quarter starting on 1 July.

As you recognise, the loss of revenue, about £150 million for the financial year 1981-82, is a matter of considerable concern. It is only some comfort that this revenue loss is likely to be offset by the increase in the sterling price of oil in recent months as the dollar has strengthened.

Yet a further disadvantage of a reduction in the oil price is that this could well be interpreted as a change in UKCS oil pricing policy. Hitherto North Sea oil prices have followed, but not led, prices of the comparable African crudes. Indeed, it appears that we get the worst of all worlds. When the oil market is tight, we follow the market up and forswear premia, or selling on the spot market and other devices to maximise oil revenues. When the market is slack, we are forced to reduce prices before others do. Certainly there is nothing to be done about this in the present circumstances. But it would be worthwhile for the official group on North Sea Oil Pricing Policy to consider whether there is a real problem here.

/Despite these real

Despite these real disadvantages, I accept that BNOC should be informed that they may go ahead with their proposed reduction of $2 a barrel for the third quarter prices starting on 1 July. This is on the understanding that all the press and other briefing should emphasise that the reduction does not signal any change in the policy that UKCS prices should be set in line with market conditions and that prices will be increased directly market conditions justify this. I also would not want to go out of our way to win credit for moving our price down before other producers. To emphasise this would be to increase the risk of international criticism when UKCS prices rise again. Indeed, it is quite conceivable, and I hope accepted, that in order to restore the relationship with the African crudes, UKCS prices will either have to rise before the African prices rise or will increase by a larger amount when they next increase.

Finally, it is worth bearing in mind that the $2 reduction in UKCS prices in no way undermines the case for the tighter fiscal regime for the UKCS announced in the Budget. The reduction in the sterling profitability of the North Sea fields caused by the lower dollar oil price is likely to be more than compensated for by the effect of the weakening pound against the dollar.

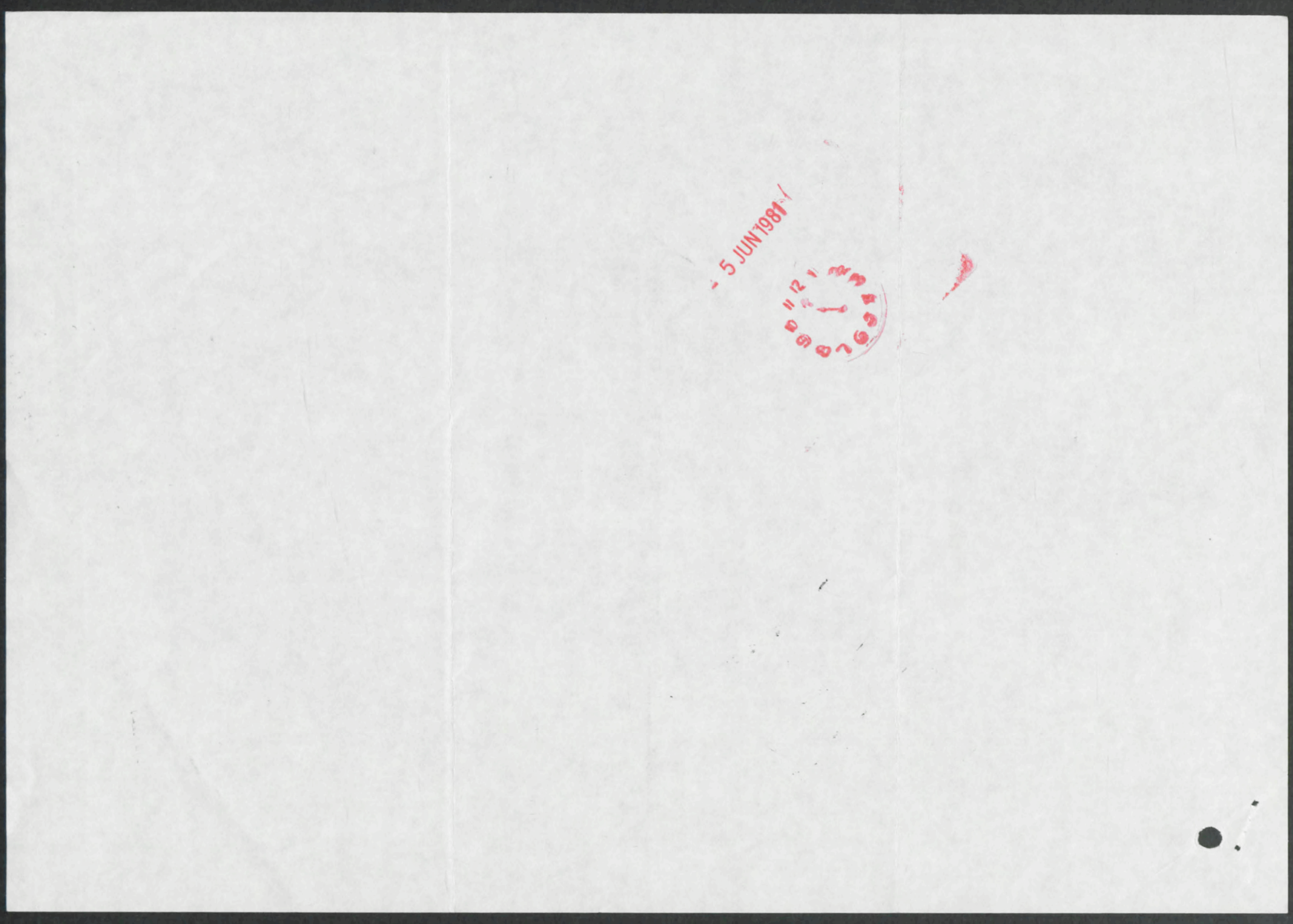
I am sending a copy of this letter to the Prime Minister, the Lord Privy Seal and Sir Robert Armstrong.

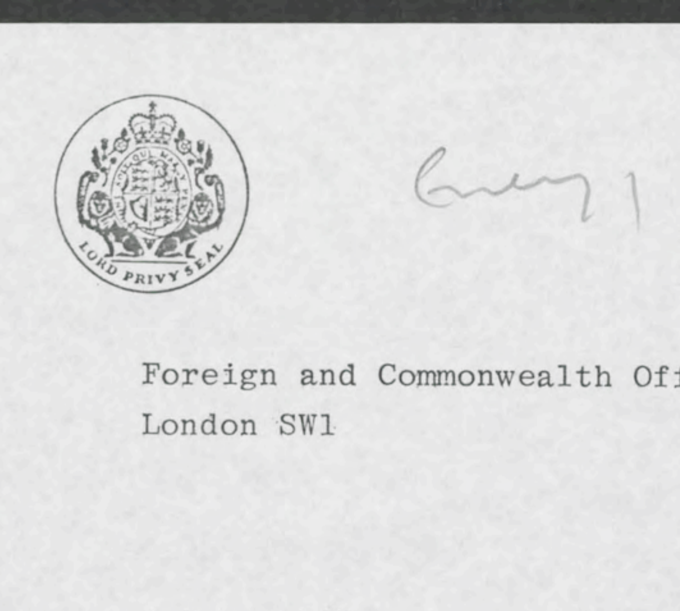
Yours sincerely

Peter Jenkins

GEOFFREY HOWE

(Approved by the Chancellor & signed in his absence)





Foreign and Commonwealth Office
London SW1

4 June 1981

Thank you for sending me a copy of your letter of 3 June to Geoffrey Howe about BNOC's request to reduce their prices by $2 a barrel with effect from 1 July. I agree that we should let BNOC go ahead and entirely endorse your view that it is important to act quickly, inter alia to secure some credit internationally without undermining our position that oil prices are set by the market. Our officials will need to stay in close touch over the terms of suitable guidance for overseas Posts should a price reduction be agreed.

I am sending copies of this letter to the recipients of yours.

The Rt Hon David Howell MP
Secretary of State for Energy
Thames House South
Millbank
London SW1P 4QJ

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
TELEPHONE: 01-211 3000

01 211 6402

The Rt. Hon. Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
London SW1P 3HE

22 May 1981

Dear Geoffrey

NORTH SEA PRICES

You will be aware that there has been much talk in the press of an oil glut and that Saudi Arabia has hinted that it will continue to keep the market over supplied until OPEC prices are reunified on a single marker price. Pressure is developing in the oil market for a reduction of prices including UKCS crude oil prices. The pressure essentially stems from the fact that companies without access to Saudi Arabian crude are now making quite substantial refining losses. If BNOC were to yield to this pressure without waiting for the Africans to move it would break the principle of following the market. I have agreed with them that they should hold their prices at least until after the meeting of OPEC in Geneva on 25 May. There is a strong possibility that there will be no agreement in Geneva and that market pressures and official African prices will remain unchanged. If this is indeed the case the pressure on BNOC is likely to be intensified. Their response would depend upon a number of factors which cannot yet be quantified, such as the number of companies seeking a price change and whether the companies concerned would be likely to allow their contracts to cease if no price reduction is agreed. It also depends on the willingness of North Sea producers to accept a lower price for oil they sell to BNOC. Even if BNOC are able to resist a price change this quarter the same pressures may still persist when the normal quarterly price review takes place to set prices for 1 July.

Other oil producing countries are able to deal with pressures to reduce price by allowing sales volumes to fall. That option is not available to BNOC since their available supplies are obtained through agreements with North Sea producers which cannot easily be over-ridden. Nor is there much opportunity for Government to take action to reduce the availability to BNOC even though in principle there

are two possibilities: reduction of oil taken as royalty in kind and reduction of output from some fields. The option to take royalty in kind can only be changed by giving notice of six months. As far as North Sea production is concerned only BP is producing above the formal profile limit and agreement to this was given because of the increased Exchequer revenues which would flow. This lack of flexibility in availability means that if BNOC finds itself under strong pressure a choice may have to be made between negotiating a lower price for UKCS crude, which would go aganist our policy of following not leading the market, and BNOC being left with some oil which might have to be sold on the spot market where the current loss would be nearly $6/barrel. From the Exchequer point of view I understand the revenue lost through an across the board price reduction of $2/barrel would be greater than the loss incurred if BNOC were forced to dispose of 100,000 barrels a day on the spot market (which is likely to be the largest volume the spot market would bear). The Corporation could well however, be unwilling to accept such a loss on its trading account without a Direction.

At this stage there can be no certainty that such a situation will arise; even if it does it may not be for some time. If the Africans neither move nor offer covert discounts I believe BNOC have real prospects of holding prices at current levels. On the other hand we should be prepared for a worse outcome which could require a decision to be taken within a week of the OPEC meeting.

I am copying this letter to the Prime Minister and the Lord Privy Seal.

Yours ever

David

D A R HOWELL

26 MAY 1981

copy filed on Energy Pt 6 Policy

cc FCO
TRADE
IND
HMT
SO
CO
CPRS
DIM

jfh

10 DOWNING STREET

From the Private Secretary

9 February 1981

UK Oil Policy: Refinery and Disposal Strategy

The Prime Minister has now considered your Secretary of State's minute of 28 January. She has also seen the Chancellor of the Exchequer's minute of 6 February.

The Prime Minister has noted the main measures that are in hand and the further possibilities that are to be looked at for improving the UK's security of supply. She has no objection to the Chancellor's proposal for an inter-departmental review of our North Sea pricing policy.

I am sending copies of this letter to George Walden (Foreign and Commonwealth Office), Stuart Hampson (Department of Trade), John Wiggins (HM Treasury), Ian Ellison (Department of Industry). Richard Dykes (Department of Employment), Godfrey Robson (Scottish Office), David Wright (Cabinet Office) and Gerry Spence (Central Policy Review Staff).

Th

Julian West, Esq.,
Department of Energy.

CONFIDENTIAL

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

UK OIL POLICY: REFINERY AND DISPOSAL STRATEGY

I have seen a copy of David Howell's minute of 28 January to you about the report on oil refinery and disposal policy. While I do not disagree with David's conclusion, which as he says has been endorsed by colleagues, I would like to make two comments on his minute:

(i) As David Howell says in paragraph 4 of his minute, some reliable oil exporters can in today's conditions demand a straightforward monetary premium for their oil. The UK has so far taken the view that our interest in a healthy international economy, our international obligations and our interests as a major consumer of energy deny us that option.

I do not by any means suggest that we should necessarily alter our present policy of linking the price of North Sea oil to the term prices of the comparable African producers; and we must of course avoid any action which would certainly increase world oil prices in a way which would be against our economic interests. But the price obtained for North Sea oil has a direct impact on the PSBR through Government take from the North Sea and less significantly through BNOC's revenues.

/In view of

In view of the importance of maximising Government take and keeping down the PSBR, I believe it would be timely if officials from the Department of Energy, Inland Revenue, Treasury and the FCO (and perhaps BNOC) could review our North Sea pricing policy in order to check that we are not missing any legitimate and sensible opportunities here.

(ii) Paragraph 5 of David Howell's minute refers to my scepticism about the creation of substantial additional reserve production capacity. This understates my position. The creation of reserve production capacity would be very expensive and if achieved through production cutbacks, would reduce Government tax take from the North Sea in the short and medium term thereby increasing the PSBR. I have already told David Howell that I would see the very greatest difficulty in any policy of production cutbacks from 1982 because of the consequences for the PSBR, which would be in clear contradiction to our general economic and monetary strategy. The latest forecasts of Government take from the North Sea over the next few years are lower than expected, partly as a result of lower production forecasts. This makes the difficulties of production cutbacks even greater. (The table attached shows the progressive decline in the forecasts of oil production over the next few years; revised figures on North Sea tax take will be available at the time of the Budget.) As I have told David Howell and other colleagues, I see little prospect of Treasury agreement to the creation of additional reserve capacity if it involves any adverse consequences for the PSBR.

/2. I am

2. I am sending a copy of this minute to the Foreign Secretary, the Secretaries of State for Trade, Energy, Industry, Employment, Scotland, Sir Robert Armstrong and Mr. Ibbs.

(G.H.)

6 February 1981

CONFIDENTIAL

TABLE I: NORTH SEA OIL PRODUCTION FORECASTS* m. tonnes

	JUNE 1979	OCT 1979	MARCH 1980 (MTFS)	JUNE 1980	INDUSTRY ACT (NOV. 1980)	JANUARY 1981	FEBRUARY 1981
1979	76	77	77	77	77	77	77
1980	94	95	83	81	81	80	79
1981	106	110	99	91	91	88	88
1982	125	122	110	103	103	102	101
1983	128	129	117	112	113	112	105
1984	131	131	126	119	121	118	110
1985	127	129	126	115	117	120	118

*including natural gas liquids, measured in million tonnes of oil equivalent

CONFIDENTIAL

Energy

Prime Minister

The first fruits of yesterday's meeting.

TL

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

01 211 6402

Tim Lankester Esq
10 Downing Street
LONDON
SW1

23 December 1980

Dear Tim,

HEAVY FUEL OIL PRICES

When the Prime Minister saw my Secretary of State yesterday to discuss nationalised industries, she asked for a speaking note on heavy fuel oil prices to industry taking in the fact that Continental prices are now generally above ours. I enclose this and a graph of trends over the last few years. The graph clearly shows the UK reasonably in line with France and Germany from 1976 to 1979. The French tend to be below both Germany and ourselves because of their lower tax, which is hardly compatible with their public international position on reducing oil consumption.

In 1980, however, we went substantially out of line, something we first spotted and took up with the companies in April. Prices on the Continent tend to react more rapidly to spot market changes than here because of the possibility of barge traffic from Rotterdam into France, Germany and Benelux. (Italian prices are controlled). As a result their prices tend to fluctuate more than ours. They are lower than ours when the spot market is weak - higher when it is strong. Other factors this year have included the timing of contract negotiations here in relation to spot price and exchange rate fluctuations.

The situation has, at least temporarily, corrected itself. The enclosed table of latest EEC weekly figures shows our prices lower than in other Community countries except Italy and the Netherlands.

We are not necessarily out of the wood on this issue since the spot market situation could turn round again. We are therefore working on the costs of reducing our relatively high HFO tax, and Mr Howell will be raising this issue in the papers which he said yesterday he would submit in the New Year.

I am copying this letter to John Wiggins, Ian Ellison, Robin Ibbs and David Wright.

Yours ever,

Julian

J D WEST
Private Secretary

HEAVY FUEL OIL PRICES

SPEAKING NOTE FOR PRIME MINISTER

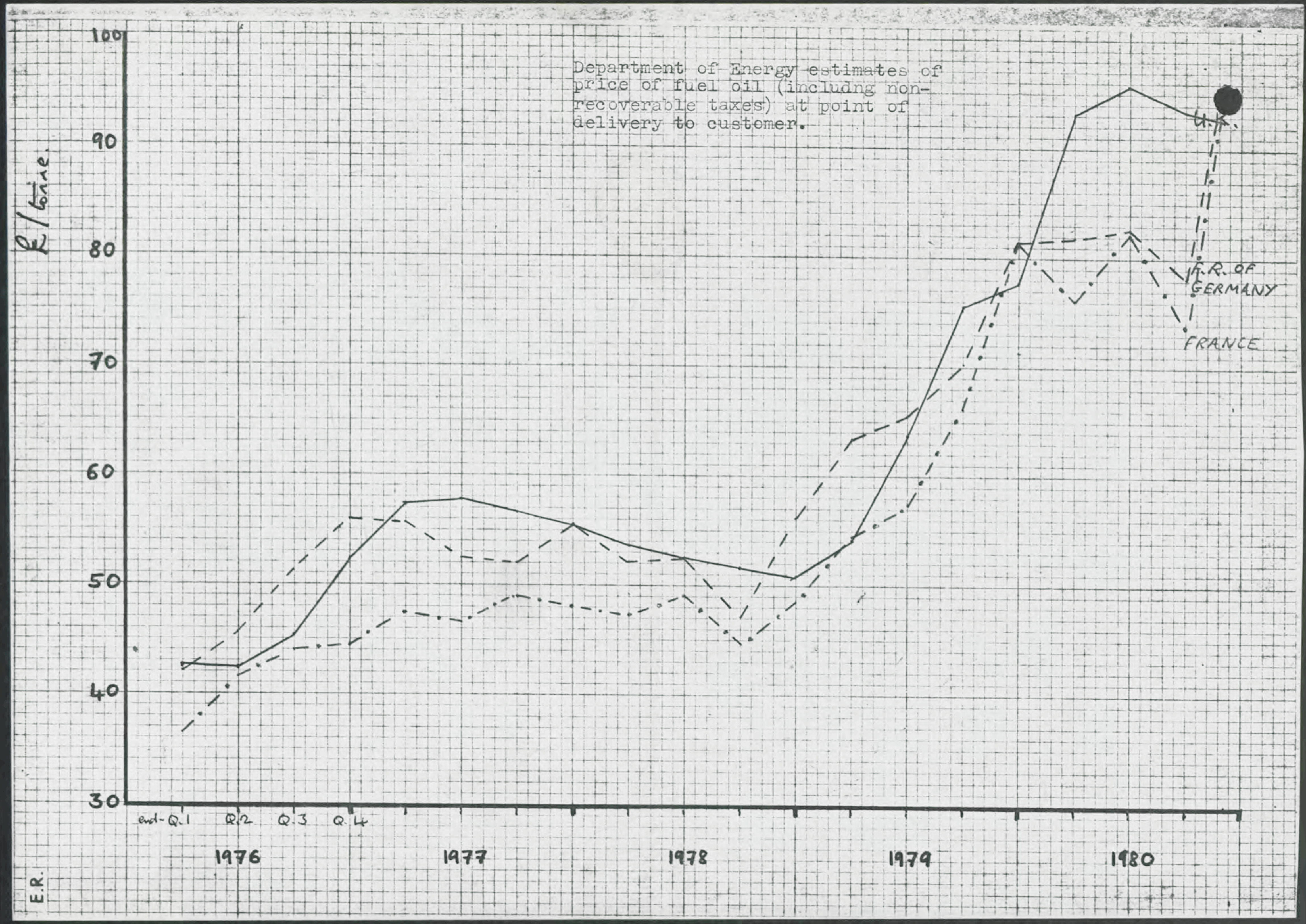
Heavy fuel oil prices have been significantly higher here than on the Continent during 1980. In earlier years our prices have been in line.

This year countries' more dependent upon the spot market for their supplies have been able to benefit from abnormally low spot prices for heavy fuel oil.

Recently however the spot market price has risen sharply and these countries are now paying for their earlier advantages.

Including taxes paid by industry, UK prices for Heavy Fuel Oil are now exceeded in almost all the other member countries of the European Community.

Nevertheless we know how important heavy fuel oil is to industry and we will be keeping the position compared with the rest of Europe under review. We have already made clear to the oil companies that we expect competitive pricing for oil products.



Department of Energy estimates of price of fuel oil (includng non-recoverable taxes) at point of delivery to customer.
£/tonne.
100
90
80
70
60
50
40
30
end-Q.1
Q.2
Q.3
Q.4
1976
1977
1978
1979
1980
U.K.
F.R. OF GERMANY
FRANCE
E.R.

HEAVY FUEL OIL PRICES, INCLUDING DUTIES PAID

BY INDUSTRY, AT 15 DECEMBER 1980

£/tonne

	Net	Duty	Duty inc. price
UK	84.4	8.0	92.4
France	95.0	0.1	95.1
Germany	91.9	3.3	95.1
Belgium	109.4	-	109.4
Netherlands	87.6	3.0	90.6
Italy	88.4	0.5	88.8
Denmark	103.1	-	103.1
Ireland	84.9	12.9	97.8

SOURCE: EEC

22 DEC 1980

CONFIDENTIAL

cc Mr Hoskyns

Energy 2

PRIME MINISTER
$2 a barrel on BNOC prices
MJS 27/4

IC to see

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

211 6402

The Rt Hon Sir Ian Gilmour Bt MP
Lord Privy Seal
Foreign and Commonwealth Office
Downing Street
London SW1

25 May 1980

Dear Ian

BNOC OIL PRICES

I am writing to let you know of an impending adjustment in UKCS oil prices.

As you will be aware the decision by Saudi Arabia to increase its official selling price by $2 per barrel has quickly been followed by practically all the other OPEC producers, including Libya, Algeria and Nigeria, the principal African producers. The Libyans and Nigerians have raised their prices by $2, while the Algerians, whose effective prices are already ahead of the other African producers because of an exploration surcharge of $3, have increased their selling prices by a further $1.

BNOC advise me that they now have no alternative but to agree similar increases in the prices they pay their suppliers, and are accordingly proposing to advise companies on Tuesday of next week of a $2 increase in their buying and selling prices. As you know, our officials have been in close touch about these developments.

I am, of course, very conscious of the need to avoid any appearance of our bringing UKCS prices into line with undue haste, but the inevitability of the BNOC move is now widely accepted following today's announcement by the Nigerians, and the fact that BNOC are proposing to hold their hand until early next week will help in demonstrating that they are doing no more than following the market in circumstances where new price levels have been clearly established.

As you suggested in your letter of 18 April our officials have been discussing together the general issue of the way in which current price determination works. I understand they are making progress and I will write to you separately about this.

I am sending copies of this letter to the Prime Minister, the Chancellor of the Exchequer and to the Secretary to the Cabinet.

Yours ever
David

D A R Howell

C O N F I D E N T I A L

Energy
Prime Minister
Mr Alexander
NBPM
[illegible]
1/5

01 211 6402

The Rt Hon Sir Ian Gilmour Bt MP
Lord Privy Seal
Foreign and Commonwealth
Office
Downing Street
London
SW1A 2AL

29th April 1980

Dear Ian

BNOC OIL PRICES

Thank you for your letter of 18th April.

As you know, HMG has no power to control the prices at which UKCS crude is traded. BNOC for its part has to pay the going market price to its supplying companies for the oil it acquires under the participation agreements, and in the event of any disagreement over prices there is provision for expert determination which is binding on both sides.

It is, of course, true that in recent months we have sought the co-operation of BNOC and producing companies on the timing of price adjustments, but we have to recognise that BNOC cannot withhold full market prices to their suppliers. Nor can we expect unreasonable delay in setting prices. Quite apart from the risk of challenge at expert determination, BNOC as the largest third party trader of UKCS oil has a limited time available under its contracts to fix its selling prices. It cannot therefore be expected to delay reaching agreement on its buying prices without inviting precisely the suggesting of compensation to which I referred in my letter of 14th April.

There is an inherent dilemma, as you point out, between on the one hand BNOC's need to move at the right moment in market terms and HMG's desire on the other from time to time to see UKCS price increases timed so as to minimise political repercussions. I had in fact been considering putting a note to colleagues reviewing the experience of recent months, and certainly agree with your suggestion that it would be useful for our officials to get together to examine the way current price determination works. I have accordingly asked my officials to

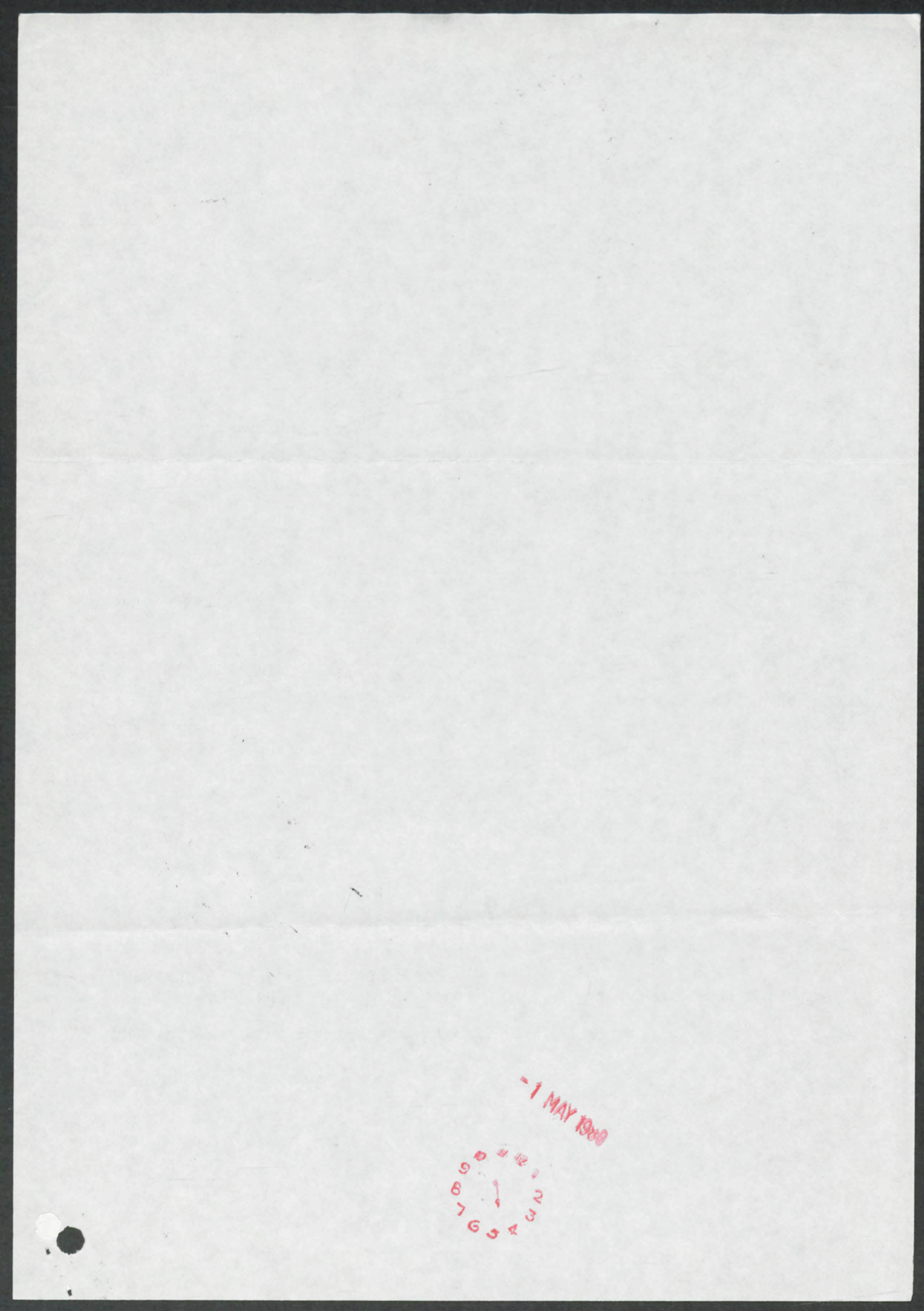
put this in hand with other interested Departments.

I am copying this letter as before to the Prime Minister and the Chancellor of the Exchequer.

Yours ever

David

D A R Howell


-1 MAY 1980

Energy

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

Rt Hon Sir Ian Gilmour Bt MP
The Lord Privy Seal
Foreign and Commonwealth Office
Downing Street
London SW1

29 April 1980

Dear Ian

BP/BNOC OIL SALES

Thank you for your letter of 14 April.

I asked my officials to get together with yours to see if a way could be found of recasting the side-letter from BP to provide better protection against any legal challenge, and was glad to learn that you are now able to accept the amended side-letter - a copy of which I attach - which has been agreed with BP.

I should perhaps add for the record that my references to clawback in our earlier exchanges did, of course, relate to the arrangements as a whole for dealing with a supply shortfall and not only termination. As you know, both BP and we think it unlikely in a sub-trigger situation that circumstances will arise in which the provision for termination would need to be exercised.

I am copying this letter and enclosure as before to the Prime Minister, the Chancellor of the Exchequer, other members of OD(E), the Attorney General and Sir Robert Armstrong.

Yours ever

David

D A R HOWELL

POSSIBLE SIDE LETTER FROM BP TO SECRETARY OF STATE FOR ENERGY

You emphasised the importance attached by HMG to BP's role as a supplier of crude oil to markets in the European Community, and asked us to consider in this context the effects of the proposed new arrangements.

The arrangements comprise Sales Agreements with BNOC, which will provide us with an estimated additional supply of 39 million tons over the years 1980/82; and an Agreement dated X concerning the supply of oil to the UK during a supply shortfall, which we entered into in order to secure these additional supplies. It is our view that taken overall, these arrangements will increase the oil available to our Associate companies including those in the EC.

It is not possible to foresee the circumstances which may arise in future supply crises and what action we would take in circumstances where our obligation under the Agreement dated X were invoked. It would be our intention to seek to cover Group requirements through operational flexibility, including drawing from stock and/or additional purchases on the open market; and, given that the Agreement refers to a supply crisis sufficiently limited in extent as not to trigger the IEA/EEC emergency mechanisms, we would expect to be able to procure the additional supplies involved without reducing the volume of supplies to our Associate companies.

This letter shall be accorded the same degree of confidentiality as the Agreement to which it relates.

29 APR 1980

CONFIDENTIAL

Energy

Foreign and Commonwealth Office
London SW1

18 April 1980

BNOC OIL PRICES

Thank you for your letter of 14 April. The price adjustments have now been made and I hope that they will not in the event give rise to difficulties. My purpose in writing now is to urge that we establish procedures to ensure that BNOC should not in future so act as to pre-empt proper Ministerial discussion of proposed price increases.

As I understand it, the whole basis of our consideration of BNOC's pricing policy last November and last January was that you had considerable scope for influencing BNOC's decisions. Indeed, your minute of 3 January to the Prime Minister sought agreement to authorise BNOC to follow a particular course. The increases then involved were greater, but the political situation just before the European Council is at least as delicate. I do not accept that BNOC should be the sole judge of what lies within their commercial competence in such circumstances.

I am still more concerned at the implications in your letter that BNOC got themselves into a position where they would not only lose money if they did not put up their selling price but considered themselves entitled to claim compensation from HMG. If they are able to proceed in such a manner, it will be an extremely important factor in any future collective Ministerial consideration of

/BNOC's

The Rt Hon David Howell Esq MP
Secretary of State for Energy
Thames House South, Millbank SW1

BNOC's pricing policy, and I should like to have a much clearer idea of what may be involved.

A useful first step might be for officials of the interested departments to consider the implications of what happened on this occasion in the light of the concerns I have expressed. It would be helpful if one of your people were to call a meeting for this purpose. I am no more anxious than you for the Government to become involved in the minutiae of BNOC's commercial activities, but pricing decisions will remain politically sensitive in the international arena and it is important that decisions should not be thrust upon us by the Corporation.

I am copying this letter to the Prime Minister and the Chancellor of the Exchequer.

yours ever

Ian

COMMERCIAL IN CONFIDENCE

N BPM
AJ

Energy

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

15th April, 1980

T. Lankester, Esq.,
Private Secretary,
10, Downing Street,
LONDON,
S.W.1.

Dear Tim,

UKCS CRUDE OIL PRICES

The Chancellor of the Exchequer has seen the letter of 11th April from Denis Walker in the Secretary of State for Energy's office about BNOC's proposal to hold the increase in Forties crude to around 50c and to propose changes to other qualities of UKCS crudes ranging from zero for flotta to about 65c for the highest qualities.

The Chancellor does not dissent from the approach set out in the Secretary of State's letter.

I am sending copies of this letter to George Walden, Denis Walker and David Wright.

Yours

John

A.J. WIGGINS

COMMERCIAL IN CONFIDENCE

15 APR 1980

CONFIDENTIAL

Energy

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

01 211 6402

NBPM
MS

The Rt Hon Sir Ian Gilmour Bt MP
Lord Privy Seal
Downing Street
London
SW1A 2AL

14 April 1980

Dear Ian

BNOC OIL PRICES

Your Private Secretary wrote to mine today commenting on my Private Secretary's letter to the Private Secretary to the Prime Minister of the 11th April reporting the small price adjustments BNOC is about to make.

BNOC do not require my authority to make these changes, which are within their commercial competence. They have said today that they are not able further to defer action with their customers without incurring losses on the differential between their buying price (which is not ultimately theirs to determine) and their selling price. To defer action tomorrow, they would require an undertaking of compensation by HMG. In any case, I cannot accept that anxiety about inappropriate comparisons between North Sea prices and Algeria's nominal price, rather than its actual price, should determine the price for North Sea oil. I regret, therefore, that I cannot accede to your request to intervene with the Corporation.

I am sending a copy of this letter to the Prime Minister and to the Chancellor of the Exchequer.

Yours ever

David

D A R HOWELL

15 APR 1980

COMMERCIAL - IN CONFIDENCE

HS

cc HMT
FCO
CO

Energy

14 April 1980

UKCS Crude Oil Prices

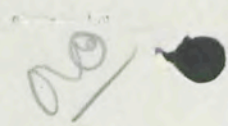
The Prime Minister has seen your letter to Tim Lankester of 11 April. She is content, subject to the views of colleagues, that your Secretary of State should act as suggested in your letter.

I am copying this letter to John Wiggins (H.M. Treasury), Paul Lever (Foreign and Commonwealth Office) and David Wright (Cabinet Office).

N.J. SANDERS

Denis Walker, Esq.,
Department of Energy.

TR



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

01 211 6402

Prime Minister
Agree subject to colleagues' views?
11/4

Yes mt,

Tim Lankester Esq
Private Secretary to the
Prime Minister
No 10 Downing Street
LONDON SW1

11 April 1980

Dear Tim,

UKCS CRUDE OIL PRICES

The Prime Minister will wish to know of some small impending adjustments in the price of UKCS oil.

Over the last two weeks of March, BNOC sought the agreement of their suppliers under participation agreements to the continuation into the Second Quarter of the prices for UKCS oil which applied during February and March. You will recall that during January BNOC had held the price of Forties crude to $29.75 per barrel (which was below the price of $29.97 per barrel for Nigerian Bonny light - then the most moderately priced comparable African crude), making a $4 increase to a price of $33.75 in February after the Nigerians increased their prices by $4.21. The spread of prices is illustrated on the attached table.

BNOC encountered some supplier opposition to this proposal for Second Quarter prices, on the grounds that the 21 cents foregone in February should be made up. Further to this, BNOC informed the Secretary of State before Easter that the Nigerians had made a further price adjustment of 51 cents in their official selling price from the 1st April, bringing the official price for Bonny light to $34.69 per barrel, and that this would make it necessary for the Corporation to concede some related adjustments in its buying prices for the current quarter. The Secretary of State told the Corporation that the market should be left to determine the appropriate current valuation for UKCS crude, but that it would be helpful to HMG if the timing of any change could be deferred for a week or two. He had in mind particularly the concerted efforts being made to deny the Iranians their $2.50 proposed price increase.

BNOC agreed to this request and confined their action before Easter to reserving their position on selling prices with those of their customers due to take deliveries over the next few days. They have today informed the Secretary of State that it is the Corporation's formal judgment that

these price adjustments must be offered to their suppliers and customers, in exercise of the Corporation's commercial responsibility and that they will act to this effect on Monday. They believe they can hold the Forties price increase to around 50 cents and will propose changes to other qualities of UKCS crude ranging from zero for Flotta to about 65 cents for the highest quality crudes in an attempt to reflect more appropriately the quality differentials between the various crude types.

The Algerians have not yet announced an increase comparable to that imposed by Nigeria, though they have told the Corporation that they will make a related change (which the Corporation expect to be arbitrarily back-dated to the 1st April) and their official price in any case already embodies a $3 "exploration premium" which takes it well ahead of UKCS prices. There has been no word of a further price change from Libya, but the latest Nigerian move in fact does no more than bring the Nigerians and Libyans into line. This series of modest price adjustments would in fact represent a move towards more appropriate market relativities between the African crudes and between them and UKCS crudes.

The Secretary of State is of course very conscious of the need to seek to avoid any change which could prejudice the action being taken to resist the Iranian price increase. That increase however is of an entirely different order and is clearly a political attempt to ratchet up the oil price rather than the sort of market adjustment represented by these modest changes. We have consistently held to the doctrine that the market must ultimately determine the levels of UKCS prices - indeed, as a purchaser, BNOC has no means of imposing a price below the market. Moreover, it is in the interests of restoring order to the market that prices should be set at latest in the first few days of a quarter and not retrospectively. Though we attach importance to UKCS prices being seen to follow and not lead world prices for comparable crudes, it is clearly defensible to move to follow the Nigerians when the Libyan and Algerian official prices (leaving aside additional premia charged in many cases) are already ahead of the others. In these circumstances, my Secretary of State is not disposed to seek to overrule the Corporation's commercial judgment on the handling of these small proposed adjustments.

I am sending copies of this letter to the Private Secretaries to the Chancellor, the Foreign Secretary and to Sir Robert Armstrong.

Yours ever,

Denis

Denis Walker
Private Secretary

SEQUENCE OF PRICE INCREASES

($/b)

Country	Libya	Nigeria	Algerian	UK
Crude	Es Sider	Bonny Light	Saharan Blend	Forties
Mid Dec.	29.78	29.97	30.00	26.02
1 Jan 80	34.50	29.97	30.00 (+3.00)*	29.75
4 Feb 80	34.50	34.18	34.21 (+3.00)*	33.75
1 Apl 80	34.50	34.69	34.21 (+3.00)*	34.20

*Compulsory "Exploration" surcharge.

11 APR 1980

CONFIDENTIAL

Energy VS

Original on Energy Pt 3 Energy Policy - World Oil Situation.

10 DOWNING STREET

From the Private Secretary

6 February 1980

Dear Bill,

OIL PRICES

As you know, the Prime Minister held a meeting here this morning to discuss the prices of Iranian and UKCS oil. In addition to the Secretary of State for Energy, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, the Secretary of State for Trade and Sir Robert Armstrong attended the meeting.

Iranian Prices

The Secretary of State for Energy said that the Iranians had increased the price of their oil by $2.50 per barrel. This was broadly in line with other increases. Despite the fact that some of the pressure had been taken off the spot market, this seemed to be having no effect on term or Government fixed prices. The dominant factor was customer nervousness about access. The contract agreed with the Iranian authorities early in the year on a price of $30 had given the Iranians freedom to renegotiate the price every month. If BP and Shell were to reject the latest Iranian increase, they would in effect be breaking that contract.

Mr. Howell said that Shell and BP would be the principal immediate sufferers if they did not purchase Iranian oil. The French and the Germans would suffer in the longer term since much of BP's oil went to Germany and of Shell's to France. In the short-term, however, it was easy for the French, e.g. M. Giraud, to adopt a relaxed attitude. Even the Germans were being somewhat ambivalent. Count Lambsdorff had told the Americans that he favoured concerted action towards Iran while taking with Mr. Howell the line that he would prefer to let market forces operate. As for the Americans, their oil companies were buying oil at higher prices throughout the Middle East. This was the wrong point in the oil price spiral for Britain to be asked to make a stand.

The Prime Minister asked whether there was any possibility of getting oil from Saudi Arabia or ARAMCO to make up for any short-fall in the supply from Iran. Mr. Howell said that he had raised this point with both the Saudi Government and with Mr. Duncan but had got nowhere. Shaikh Yamani's unwillingness to give the UK a share of Saudi production probably reflected both the peculiarities of the ARAMCO arrangements in Saudi Arabia and generalised nervousness about American reactions.

/The Secretary of State

CONFIDENTIAL

The Secretary of State for Trade said that he thought it important to bear in mind our broader relations with Iran. Eventually the situation in that country would improve and commercial activities might open up for us there. If we distanced ourselves from Iran now, the effect on our future prospects would be unhelpful. This might apply the more strongly if a deal was done with ARAMCO. The Foreign and Commonwealth Secretary said that the same argument applied to our political relations with Iran: once the hostages were released there might be an important role for the European Governments in Iran. We should not be pushed into action now which might prejudice our chances of exploiting that future opportunity.

Summing up the discussion, the Prime Minister said that it was agreed that we should go ahead with the Iranians on the basis of the new price demand. But the Secretary of State for Energy should also get in touch with the Americans and others to try to arrange for a concerted policy on holding off from the purchase of Iranian oil in the months immediately ahead in the hope that market forces would operate. Contacts with ARAMCO as a possible source of alternative supply should also be pursued. Finally, it was agreed that if there were to be joint resistance in future to demands by "the OPEC hawks" the Iranians should not be regarded as a result of today's decision as a special case who would be excluded from the operation of such a policy.

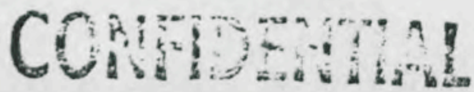
UKCS Prices

The Secretary of State for Energy said that the price of Libyan, Nigerian and Algerian crudes had now risen to $34 or over, and it was no longer possible for BNOC to hold their prices at $30. There were two options - either to force BNOC's price to arbitration, or to allow BNOC themselves to settle a price at not more than $34. His own initial instinct had been to go for arbitration, but he now felt that on balance it would be better to allow BNOC to negotiate the price. If expert valuers were brought in, the price was likely to go even higher. Furthermore, the arbitration arrangements differed as between the various companies with which BNOC had contracts; different results would therefore almost certainly emerge, and this would cause confusion.

The Prime Minister said that BNOC had done well to hold the current price of $29.75 and she was concerned about the implications for the RPI of allowing UKCS prices to go up now. She wondered whether, were it not for the Treaty of Rome, it would be possible to have differential prices for North Sea crude - with world prices for exports and a lower price for crude entering the UK market.

Mr. Howell said that a differential price system would either require physical controls on the movement of oil, or subsidies from the Government on oil sold in the UK. Although the continued hiking of prices by OPEC was deplorable, any attempt by the UK to move away from market determined prices would be contrary to the Government's whole philosophy - and in any case this could not be done within the EEC rules. The Chancellor added that even if we were able to hold down UKCS prices, product prices would still move in line with the market. From a revenue point of view, it was better if UKCS prices went up as well.

/The Prime Minister



The Prime Minister then raised the question of from which date the new BNOC price should be operative. She hoped that on this occasion there would be no back-dating - particularly since the Nigerians appeared only to have moved their prices on 4 February. Mr. Howell explained that BNOC had notified their customers on 1 February that the price would go up from that date, and they had done this only in response to the price increases announced by Algeria, Libya and Kuwait at the end of January. If the BNOC price increase was back-dated to 1 February, as he proposed, it could still be presented as being in response to the market. The Foreign and Commonwealth Secretary expressed the hope that use of the word 'premium' in relation to the price could be avoided.

Summing up a brief discussion, the Prime Minister said that Ministers were agreed that BNOC should be authorised to negotiate a price of not more than $34 on the lines suggested in paragraph 12b of Mr. Howell's minute of 5 February; they were also agreed that the price increase should be back-dated to 1 February but that it should be made quite clear that the decision to raise prices had been taken after the other producers had already moved.

I am sending copies of this letter to George Walden (Foreign and Commonwealth Office), John Wiggins (H.M. Treasury), Stuart Hampson (Department of Trade) and to David Wright (Cabinet Office).

Yours ever

Michael Alexander

W. J. Burroughs, Esq.,
Department of Energy.

Energy

Ref.A01343 CONFIDENTIAL

Original on Energy Pt 3
Energy Policy. Discussion
on World Oil Situation.

PRIME MINISTER

OIL PRICES AND IMPORT TARGETS
(The Secretary of State for Energy's minute to you of 5 February)

Mr Howell's minute, to be discussed at your meeting at 9 am tomorrow, covers three issues: Iranian prices; UKCS prices; and import targets. The first two are urgent, the latter less so. I suggest that the meeting concentrates on the price issues and leaves import targets for the time being (Mr Howell in paragraph 16 of his minute promises a separate submission on this).

2. Iranian prices: The Americans are trying to get a united front against the Iranians' latest $2.50 a barrel increase in their prices. But these new prices are not particularly out of line with the market and if we refuse to buy the Iranians will sell to others. The impact of any resulting shortfall in supplies would fall on European consumers and on Japan and on BP and Shell. The Americans would be unaffected. Moreover, this hardly seems the moment to apply a new screw to the Iranians (the Americans are themselves holding off their economic measures). Your colleagues may therefore find little difficulty in accepting Mr Howell's suggested line in paragraph 17(a) of his minute - which besides price recommends that we should not agree to holding a meeting on Iranian oil prices in London but should be ready to join in discussions elsewhere at a suitable time.

3. UKCS prices: The North African producers have moved to an oil price around $34 a barrel. BNOC is still selling similar crudes at $29.75 a barrel. We cannot afford to hold BNOC back from matching these prices (even if the independent North Sea producers would let us) and the question is how we best move to, say, $33.75 a barrel without attracting unnecessary criticism from our European partners. Mr Howell sets out the alternative techniques in paragraph 12 (a) and (b) of his minute.

He recommends (b). There is in fact no simple solution because the interests of the companies producing in the North Sea vary widely and some would welcome a low price (for tax reasons) while others would want the most they could get. Moreover, while arbitration offers a neat way out in principle the mechanics leave a great many uncertainties about the outcome. And for arbitration to take place BNOC would still have to declare its hand on prices. Mr Howell's recommendation for leaving the outcome to "careful and determined negotiation" by BNOC is probably the best way out. (The reference to paragraph 13(b) in paragraph 17(b) in Mr Howell's minute is a misprint for 12(b)).

CONCLUSION

4. It is likely that Mr Howell's recommendations on prices will be accepted. The question of import targets should be put on one side pending his further minute.

RTA

Cabinet Office
5 February 1980

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Original on Energy Pt 3 Energy Policy. Discussion on World Oil Situation

PRIME MINISTER

OIL PRICES AND IMPORT TARGETS

There have in the last few days been three developments which we need to consider together and on two of which we need to take urgent decision:-

(a) Iranian prices

The Iranian authorities told the oil companies including BP and Shell at the end of last week that they were increasing prices for oil under the contracts concluded at the beginning of the year by $2.50 a barrel following the increase of $2 a barrel by Saudi Arabia, Iraq, Kuwait and the Gulf States. BP and Shell are temporising but Shell loaded two tankers on 1 February the day after they received the notification. Charles Duncan telephoned me on Friday evening to say that the Americans were trying to get up a Western front against the Iranian demand and to ask us to ensure that BP and Shell did not commit themselves while discussion continued. He claimed to have the support of M. Giraud, who was in Washington, and he has been in touch with the Germans and the Japanese. The latter have in consequence told their companies to hold off for several days. Our most recent information from Washington says that Giraud has agreed that the line should be $30 for Iran. Lambsdorff told me this morning, however, that he was convinced that this attempt by the Americans to generate action was misplaced and that the right response would be a very low-key understanding on the part of all the major consumers to try and take the heat out of the market, refrain from heavy buying for a couple of months and let market forces operate for us. The Germans will certainly not welcome precipitate action on Iran.

(b) UKCS Prices

We decided last month that BNOC should be seen as a moderating influence on world oil prices by not setting a price in the first quarter of 1980 above about $30 and leaving suppliers who were not content with that

price to take the issue to arbitration if they wished. Before the spate of further price increases in the Middle East and Africa in the last few days BNOC had gone a long way towards establishing UKCS prices at least for January at around the $30 level. The fact that Libyan, Nigerian and Algerian crudes, which are the closest in quality to UKCS crudes, are now all priced above $34 makes this position no longer tenable.

(c) Import Targets

President Carter said in his State of the Union Message that the US Import ceiling for oil imports in 1980 would be 8.2 mbd (comfortably above likely outturn which we estimate at 7.9 mbpd) and that the US would be willing to reduce their target if other oil consuming countries individually join in a fair and mutual reduction. The Americans are building up heavy pressure for a reduction in 1980 targets at the IEA Ministerial planned for late March. Lambsdorff confirmed that he like us was totally opposed to the target cutting exercise and that he would seek to persuade Duncan to defer the IEA Ministerial.

2 This complex of issues is likely to dominate internationl energy discussion over the next few months leading to the Venice Summit. We need to handle them with great care if we are to safeguard UK interests and at the same time avoid damage to our relations with the Americans and/or our European partners.

3 Immediately there are two questions which need to be resolved - our response to the US approach on Iran and action on UKCS Prices.

4 Both need to be looked at against world oil prospects. Our own latest forecasts and those of the IEA suggest that demand for OPEC oil in 1980 will be about 29 mbpd compared with 31½ mbpd in 1979. Spot prices have shown a marked downturn through January and there are even suggestions now that cargoes are being disposed of at a loss. We see no sign, however, that term prices - particularly for light oils - are likely to weaken. More over the supply condition is general remains extremely fragile. But unless there is a sharp cut in OPEC production deliberate or accidental - oil prices may have reached a temporary peak.

Iranian Prices

5 Although they will try to negotiate better terms BP and Shell both feel that they have little option but to accept the Iranian demand. They need the oil (125,000 bpd for BP and 95,000 bpd for Shell). The Iranians have the right under the terms of their contracts to increase Government Selling Price at any time. The increase of $ 2.50 a barrel is only 50 cents more than that imposed by the Gulf states. If, however there were to be a firm stand which resulted in a loss of Iranian supplies, BP and Shell argue that there should be a safety net under which the Aramco partners and perhaps other US companies would give help.

6 While it is, no doubt, the case that the price now being asked by the Iranians is high for oil of that quality in relation to Gulf prices (though not in relation to North African prices) I do not share the American view that the Iranian increases can be treated in isolation as a principal destabilizing influence. On the contrary the latest Kuwait and Iraq increases and the prices set by the African producers matter far more. Concerted action on the part of consumers only makes sense at this point if it is taken as part of a united front with the moderate elements within OPEC, against irresponsible price increases more widely.

7 Unless there are non-oil reasons for trying to exert pressure on Iran, with all the risks for Shell and BP and their mainly continental European customers, I do not see how we could reasonably invite the companies to break their existing contracts.

/8 The Americans

8 The Americans have asked whether we would be prepared to hold a conference in London later this week, without publicity, to consider the Iranian issue. I am sure we should not take the lead in this way but I would be prepared to participate in an informal meeting a little later on to look at the possibilities of making use of what we see as favourable market forces in the wider context.

9 Whatever we decide we must carry the Japanese with us.

UKCS Prices

10 BNOC, if left to themselves, would now offer their suppliers a Forties crude price of $ 33.75 (with related prices for other UKCS crudes) from 1 February. They would regard this as a moderate market price which might be accepted by the oil producers as a fair recognition of what has happened in recent days. BNOC wish to avoid disagreement over price leading to a reference to experts i.e arbitration; they believe that the few independent experts are of poor quality and that the results of arbitration would be unpredictable and unsettling for the future.

11 There is some force in their view. But a $4 jump offered by BNOC could attract a great deal of international criticism even though e.g US companies have been buying at higher prices - no one would choose to believe that the BNOC offer was not inspired by HMG.

12 Ideally we would find a solution which allowed market forces to settle UKCS oil prices at reasonable levels without exposing HMG

/to the

to the criticism that it was responsible for the results. There are two ways in which the pressures on the Government might be mitigated:

(a) by forcing the price to arbitration. This could be easily achieved by BNOC offering an unreasonably low price and sticking to it. In this way BNOC's moderation is clear and the final decision is taken by independent experts; <u>or</u>

(b) the oil producers forward their price demands and BNOC, after careful and determined negotiations, settle (as they believe they can) for not more than $34. This also can be presented as a valiant attempt by BNOC to moderate the excessive demands of the producers while avoiding arbitration which might well result in a higher price. It would of course be essential that BNOC only reacted and was not the first to propose a price.

13 (a) looks superficially attractive since it removes the decision from HMG's control. But in addition to the points in para 10 there would be a serious technical risks, eg in one case the participation agreement requires an arbitrator to choose either the buyers or the sellers suggested price. More generally we cannot really hope to escape some responsibility for what happens in a world where every producer government intervenes on pricing policies, and when we regard it as essential to retain a trading capability for our own security of supply.

14 I favour (b) above which if properly stage managed will get us back with the position of following nearly the Libyans, Algerians and Nigerians but being dragged there under duress. This should put us in the most flexible position we can hope for in the future.

15 As for the price at which BNOC sell oil to refineries, I have insisted that they give notice that this price will not be less than the price ultimately fixed at which they buy.

16 All this has implications for import targets on which I will be minuting you separately.

A suggested line:

17 I think the way through is to:

(a) tell the Americans that we do not think it is now possible to prevent the 1 February Iranian increase but that we are very ready to join in discussion with them and the other main consuming countries soon about joint resistance to future unreasonable demands by the OPEC hawks provided action is not confined to Iran (but we should not hold a meeting in London);

(b) urge BNOC to proceed as in para 13(b).

18 The US Administration clearly wish for electoral reasons to provide a convincing demonstration of American leadership at the IEA Ministerial and at Venice. This is likely to be at the expense of European interests without leading to any new action by the US to help solve its own energy problems. We must do what we can to modify these US pressures

19 You may think it useful to have an early meeting of the small group which discussed these issues before Christmas.

20 I am sending copies of this minute to Peter Carrington, Geoffrey Howe, John Nott and Sir Robert Armstrong.

JH.

5 February 1980

253-7500

Ext 2005

P.0202

MR LANKESTER

cc: Mr Wade-Gery
Mr Franklin
Mr Mountfield
Mr Wright
Mr Kind

THE PRICE OF NORTH SEA OIL

You asked David Wright this morning for any information we could gather on current moves on the price of North Sea oil following the recent further rise in Nigerian and Algerian prices. I accordingly called in representatives of the Departments concerned for an informal discussion of the situation. Briefly:-

(a) Mr Howell is likely to be minuting the Prime Minister tonight or tomorrow morning suggesting that the North Sea oil price should be settled by arbitration. His basic argument will be that this is the best way to avoid international flak. The Foreign and Commonwealth Secretary is likely to support him on the same grounds. The Chancellor of the Exchequer's reaction is less certain because he is known to be worried about the uncertainties attaching to an arbitrator's price determination and the consequent loss of control of the revenue and balance of payments effects of the North Sea price.

(b) It is common ground, apparently, that the current market value of "forties" crude is around $33.75 or $34 a barrel as against the current price of $29.75. The difference represents a great deal of money to the Exchequer and the balance of payments.

(c) Uncertainties about arbitration stem basically from the fragmented state of the oil market - with no clear "marker" on which an arbitrator can stick; variations in the arbitration clauses of BNOC's various contracts which could lead to some maverick findings (there could be a number of separate arbitrations); the restricted number of potential arbitrators available - who would know perfectly

well that they were engaged as much in a political as an economic exercise; and, in terms of presentation, the difficulty of ensuring that the initiative for arbitration came from an oil company rather than from BNOC. It is also relevant that an arbitrator could apparently fix a price for a whole quarter's supplies and thus remove the possibility of adjusting upwards to any further market rises on a monthly basis (this may be less of a danger if the spot market continues to fall as it is doing at present).

(d) In all of this it has to be remembered that the interests of the North Sea producers who are also refiners is best served by a low North Sea price (they shift their profits from the heavily-taxed upstream area to their barely-taxed downstream activities). Such companies control 80 per cent of the output. None-refining producers, on the other hand, want the highest price they can get - and this group includes most of the small "British" producers. BNOC may have to conduct some pretty elegant footwork if it is to come out of the arbitration maze with a high effective price and without itself having had to appear to be forcing the pace on the offers which it will need to make before arbitration can come into play.

(e) There is also a rather more devious longer-term argument. Arbitration is built into the Participation Agreements which were constructed under pressure from HMG. If we now use arbitration and do not like the results, we may be forced into an overtly-administered price. If on the other hand the arbitrator's price is satisfactory, more perceptive overseas critics might say that we had set up the arrangements as a perfidious device to obtain a high price without taking responsibility for it. The former is I think a much more serious risk than the latter.

2. We will of course offer advice when we know precisely what Mr Howell has recommended.

P Le CHEMINANT

4 February 1980

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Energy
Prime Minister
To note - especially implications for the budget.
TL 21/1

Econ Policy
cc Public Expenditure Pt 7

PRIME MINISTER

NORTH SEA OIL OUTPUT

The Department of Energy's latest estimates of North Sea oil show output rising somewhat more slowly over the next few years than the estimates made last autumn. Estimation of the oil flow is, inevitably, highly uncertain but, while the precise figures are debatable, there are quite strong reasons for revising down the earlier ones. There have been technical difficulties in bringing some of the newer fields into production, revised production profiles from the companies operating at Forties and Dunlin and the recently announced restriction on flaring.

2. The two estimates are compared in the table below:-

Total North Sea Oil Production* (m tonnes)

	1979	1980	1981	1982	1983	1984	1985
December 1979 Forecast	77	86	101	110	117	126	127
September 1979 Forecast	77	95	110	122	130	131	128

(* including Natural Gas Liquids)

Over the years to 1983 the reduction amounts to about 40m tonnes.

3. We are, of course, already considering the case for slowing down the oil flow in these years in order to spread the benefits

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further into the future. These new output estimates show that the peak is a little further away than we thought. But there still is a peak and we shall need to consider the implications of it when we resume our discussion of depletion policy.

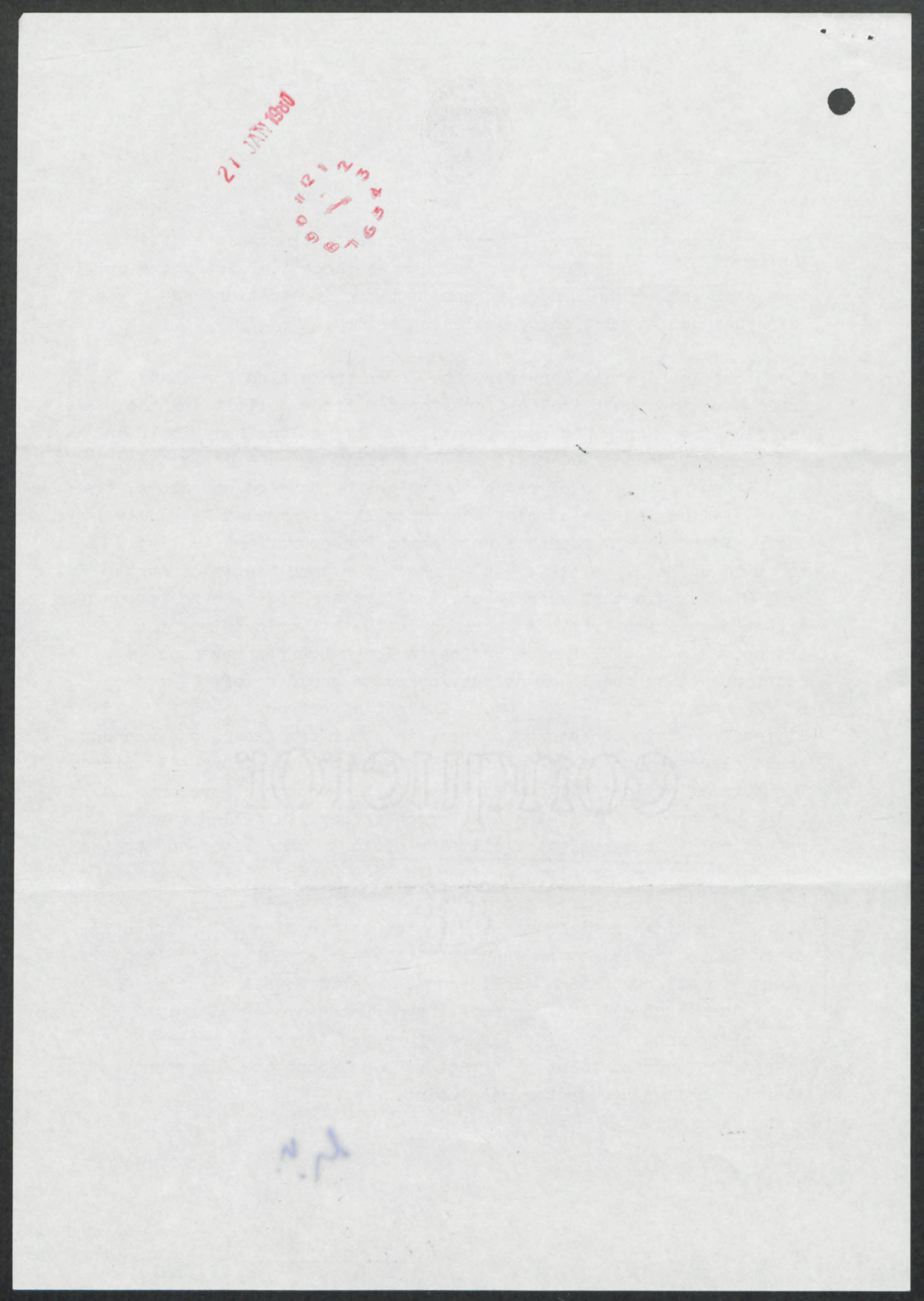
4. More immediately, however, the lower production forecasts would have important implications for the trade deficit and the tax flow from North Sea operations. In themselves they imply an addition of around £900 million to the visible trade deficit in 1980 (though, because of reduced earnings by foreign operators, the adverse effect on the current account will be somewhat less). Their effect on tax revenues from North Sea operations is likely to build up fairly slowly, but to reach very substantial amounts by 1983-84. In that year it could offset the addition to revenues expected to arise from the increase in the oil price since the autumn. In 1980-81 the reduction in North Sea tax revenues attributable to the lower output forecasts could be of the order of £200m and in 1981-82 £500m. The net effect on the PSBR would differ from this because of changes in other tax flows, and account would also need to be taken of the effects of the higher oil prices. These ramifications will be examined in the economic forecasts now being prepared; but if the new forecasts were fulfilled these reductions in the projected oil flow would in themselves add to the serious budgetary problems we face in 1980-81 and 1981-82.

5. Since these revisions are relevant to the discussion of public expenditure at Cabinet on January 24th, I am circulating this minute to all our Cabinet colleagues. David Howell rightly emphasizes that all the figures I have quoted are inevitably imprecise; and should ideally be expressed in ranges rather than in single figures. But he agrees with me about the importance of alerting colleagues to the main point.

G.H.

(G.H.)

21? January 1980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cc Lord Privy Seal's Office

ENERGY

10 DOWNING STREET

From the Private Secretary

17 January 1980

The Prime Minister has considered your Secretary of State's minute of 14 January about UKCS crude oil prices, the minute of 15 January from the Minister of State, Foreign and Commonwealth Office, and Mr. Howell's further minute which came in yesterday.

The Prime Minister has decided that, on balance, it would be best if BNOC stood firm on a price of $30 per barrel in their negotiations with the oil companies. She believes that if BNOC take a tough line in the negotiations and insist on $30, there is a good chance that the companies will not challenge them. But if in the event the companies insist on arbitration, she believes the political and tactical advantages of this course outweigh the risk that arbitration will result in a higher price than the $32 to $33 level which BNOC have asked if they can be authorised to settle at. If there is to be arbitration, this must be, and be seen to be, at the request of the oil companies: the Prime Minister does not wish BNOC to offer arbitration.

I am sending copies of this letter to George Walden (Foreign and Commonwealth Office), John Wiggins (HM Treasury) and Martin Vile (Cabinet Office).

T. P. LANKESTER

W. J. Burroughs, Esq.,
Department of Energy.

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

UKCS CRUDE OIL PRICES

I have seen a copy of David Howell's minute to you of 14th January in which he recommends that BNOC try to settle UKCS crude oil prices at around \$32-\$33, without recourse to arbitration. I have also seen Nick Ridley's comments of 15th January and David Howell's further minute of today.

2. I agree with David Howell's recommendation. It seems that there is a real prospect that arbitration would result in higher price, which, as David Howell points out, could lead to leap-frogging increases by the African producers. This would be unwelcome, particularly if our defence that we have been forced to that price would not in practice lessen the criticism.

3. I also agree with David Howell's proposals that additional money should be offered in the form of a supplementary payment or surcharge on a basic price of \$29.75 for Forties crude.

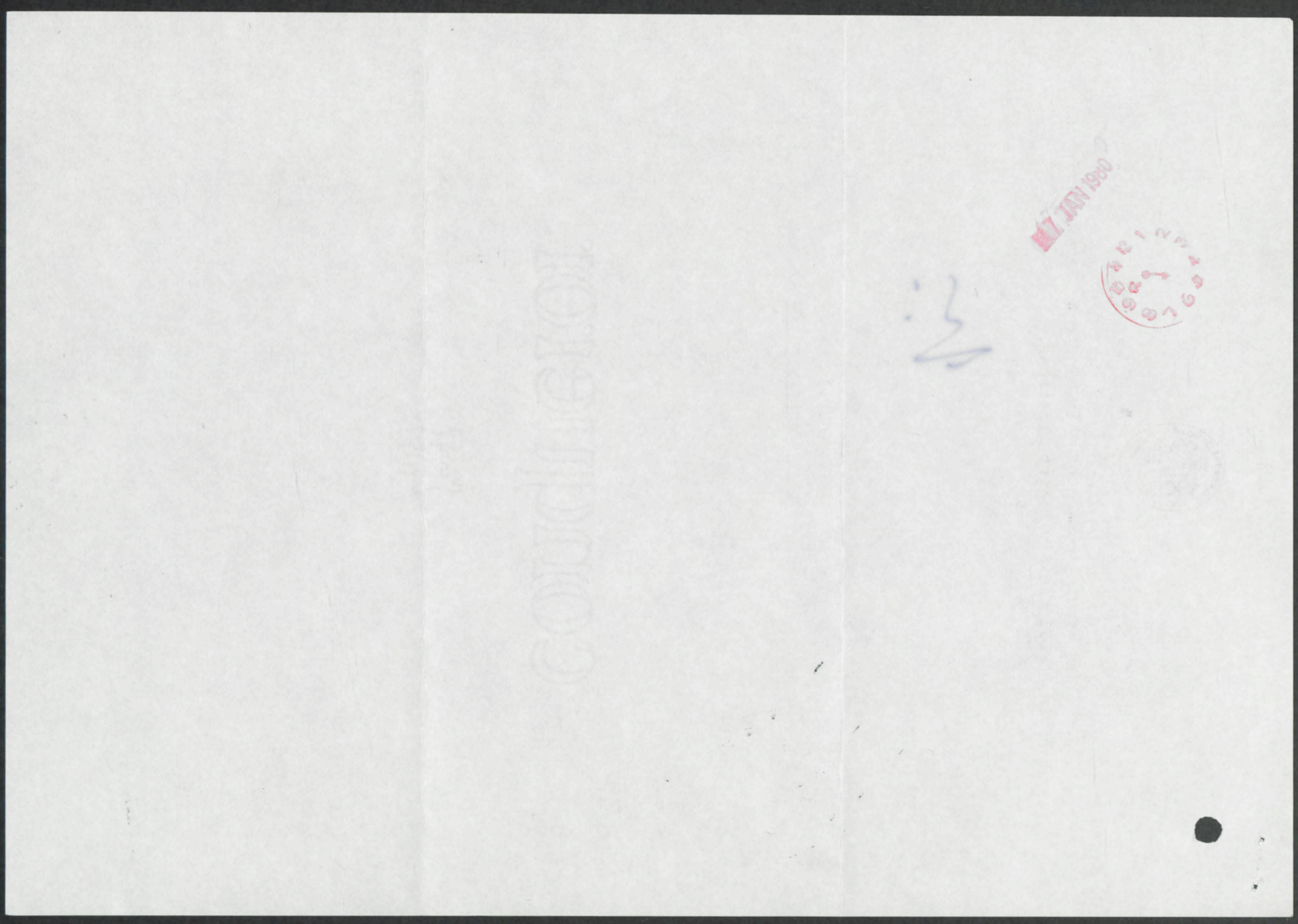
4. Finally, I think that it would be worthwhile making clear to, for example, the Germans and Americans our difficulties in reaching a decision though, of course, we should do this in a way which does not suggest to them that they have any say in our decision. But an early approach to the Germans and Americans might help disarm any adverse reaction.

/5. I am sending

5. I am sending copies of this minute to Peter Carrington, David Howell and Sir Robert Armstrong.

(G.H.)

17 January, 1980



PRIME MINISTER

UKCS CRUDE OIL PRICES

You agreed last week that BNOC should try to reach agreement with the North Sea companies on a first quarter price of around $30 per barrel. But you also asked, in case they were unable to reach agreement on this price level, for an assessment of the pros and cons of the arbitration approach.

Mr. Howell, in his minute at Flag A, now says that the oil companies without refinery interests here - mainly American companies - will not accept a $30 price. (BP, which of course does have major refinery interests, are reported to be willing to accept a $30 price. But Energy say that it is only because they want to maximise their downstream profits and minimise their upstream profits so as to reduce their tax liability. If they sell crude at $30 to BNOC, their refineries can buy it back at $30; but they still will increase their end product prices and thus increase their downstream profits). Mr. Howell proposes that we should authorise BNOC to reach agreement on a price of $32 to $33 - to comprise a basic price of about $30 plus a "temporary surcharge".

Mr. Howell has only dealt cursorily with the suggestion that it might be better to go to arbitration. His conclusion, supported by his further minute at Flag B, is that arbitration is to be avoided. His reasons are:

(i) Arbitration is likely to result in a higher price. The minutes do not say what this is likely to be. But on further probing, I am advised that it is most likely to be between $34.50 and $35 - though the Department emphasise that it is very hard to form a view on this.

(ii) Mr. Howell does not think that international reaction will be influenced by the method of determining prices; instead, he believes that it will be

/wholly

wholly conditioned by the level of prices which emerges. He is particularly concerned about the African producers and, to a lesser extent, about Middle East producers, who - he believes - will take a higher price as a cue for further price increases.

The FCO have minuted(Flag C) that there are strong tactical arguments for going to arbitration, provided this route does not result in a price higher than $34.50 to $35. If it was likely to result in a higher price, they would go along with Mr. Howell's proposal that BNOC be authorised to negotiate prices in the $32 to $33 range.

The difference in the price which would be likely to result from arbitration is not all that great. In any case, the economic arguments are not necessarily against our going for a higher price. Higher North Sea prices, of course, mean higher PRT and other payments to the Exchequer. These could be entirely offset if our higher prices triggered off higher prices elsewhere, and thus further damage to the world economy and indirectly to our economy. The outcome - to say the least - is uncertain.

This is a difficult decision to take - not made easier by Energy's inability to provide a proper assessment. The point in the political equation which Mr. Howell does not mention is the likely reaction of our Western allies: as you have said, arbitration - especially if demanded by American oil companies - could make our position vis-a-vis the Americans much easier. The counter-argument, which I am told Mr. Howell espouses, is that by not going to arbitration we could take credit for not allowing North Sea prices to rise to "market levels".

The Chancellor held a meeting on this issue this afternoon. He is inclined to support Mr. Howell because he wants to minimise the risk of leap-frogging by African producers and because he feels we will get the opprobrium for further price increases whatever our approach. But he accepts that the decision is finely

/balanced.

balanced.

Mr. Howell wants a decision today.

My own instinct is that BNOC should be told to stand firm at $30, and if the oil companies will not accept this, the agreed arbitration procedures - which involve the two sides calling in an independent expert valuer - should be allowed to take their course.

Not a cent above Nigeria. P.

$29 – 75 (?)

I doubt very much whether American Co's will challenge that — they would have to take into account the effect of such action on their own future reputation.

M.

16 January 1980

B

PRIME MINISTER

UKCS CRUDE OIL PRICES

Since we need to take a decision today on UKCS oil pricing, I should comment quickly on Nicholas Ridley's minute to me of 15th January.

The arbitration route in fact embraces the procedure set out in his third paragraph. If we follow this route, BNOC will, of course, stick on their present offer and the companies in question on their rejection. The contract then provides for resolution by an expert, by a defined procedure. This is not an additional option. If the price goes up for the arbitrated minority it will go up for all the majors as well.

Newspaper reports of BP's action should not be given much attention. What BP has done is to set a provisional price for UKCS oil transferred to its own affiliates. My minute to you of 14th January explained that it suits an integrated company to set a relatively low price and take its profits downstream. We have tested informally the weight likely to be attached by an independent expert to evidence of internal pricing by BP (or any other major, integrated company) and, as we expected, this would <u>not</u> be regarded as an objective valuation.

We are left with the original dilemma I posed: that the UKCS price is going to rise, one way or another, above the official price of at least some African crudes and that this will attract criticism from oil consuming countries. The judgment we have to make is whether resort to independent determination is likely to do more harm than good. My view is that a price set by an independent expert is likely to be <u>higher</u> than a revised price negotiated by BNOC, though it is not possible to say whether the expert's price would be above or below

Libyan official price: $34.50-35.0

the current Libyan price (remembering that it is not official prices which gauge the world market price, but the price at which term transactions are actually taking place in the market). It is my judgment that it will be the absolute level of the price finally established which will determine international reaction and that any international credit won by the choice of route to the price will be dissipated as soon as that price emerges, especially if it is unnecessarily high. I therefore re-echo my recommendation that I should be authorised to tell BNOC today to make revised offers in the range of $32 to 33.

I am sending copies of this minute to the Secretary of State for Foreign and Commonwealth Affairs, the Chancellor of the Exchequer and Sir Robert Armstrong.

DH

SECRETARY OF STATE FOR ENERGY
16 JANUARY 1980

16 JAN 1980

Secretary of State for Energy

cc: Prime Minister
Chancellor of the Exchequer
Sir Robert Armstrong

UKCS CRUDE OIL PRICES

You asked for quick reactions to your minute of 14 January to the Prime Minister, and I am responding in the absence of Peter Carrington and Ian Gilmour.

2. As you say, either of the options you mention is likely to result in a price for UKCS crude above the current official price for Nigerian crude. International criticism will be inevitable, more especially if other producers take the occasion to raise their prices; and it will come at a particularly awkward time in view of the EEC budget negotiations, and of American criticism of BP and Shell purchases from Iran.

3. I wonder whether there is not a further option available to us, namely to make the companies take the initiative in seeking independent valuation. There is a difference presentationally between BNOC calling in a valuer (which could be misrepresented overseas as a tacit arrangement between BNOC and the companies to seek respectable outside support for proceeding to higher North Sea price levels), and the companies taking to arbitration a BNOC which had indicated its firm preference to stick to $30. Such a procedure would tend to depoliticise the matter, and to emphasise that the decision was not one for the government.

4. I note that the companies who want higher prices only account for some 20% of BNOC's oil availability, and that many of

/these

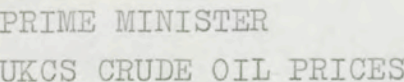
these are American-owned. The majors appear to be content with $30. Today's newspapers report that BP is already charging its customers a reference price of "29.75 and that BNOC have said that BP's new price is identical with their evaluation of Forties type crude. Is there not a case, therefore, for encouraging BNOC to settle now with as many oil majors as possible at a price around $30; to let themselves be taken to arbitration by the independents; and to cite the majors' willingness to settle at $30 as justification for their own view of the correct market price? This might help the arbitrator to arrive at a lower figure than the independent companies want.

5. If the effect of arbitration in these circumstances would be likely to set a price level roughly comparable to that which BNOC are prepared to concede anyway in negotiation, then I think there are strong tactical arguments for so proceeding. If, on the other hand, your advice is that the outcome of arbitration might be a price higher than the highest current price for comparable curde, ie the Libyan price of around $34.50-35, then I would agree that the arbitration route, despite its attractions, would not work to our advantage. In that case, I would see attraction in your idea of a basic price plus a temporary market surcharge. But we should be careful to present the surcharge as something justified only by our view that the market may shortly slacken, and not as a permanent feature of North Sea pricing: the latter interpretation would serve to encourage other producers to look for gimmicks to camouflage price increases. I would hope also that negotiated prices will not go above the range of $32-33.

15 January 1980

Nicholas Ridley

(Approved by the Minister of State and signed in his absence)



PRIME MINISTER

UKCS CRUDE OIL PRICES

BNOC has, as we agreed, been seeking to reach agreement with its supplying companies on a 1st Quarter price of around $30 per barrel for UKCS crude oil taken under participation agreements.

It is now apparent that although a price around this level would provide a basis for agreement with UK refiners, who buy more oil from BNOC than they sell to it and would prefer to take their profits and pay tax downstream, it will not be acceptable to those companies without refinery interests in the UK and who account for some 20% of BNOC's oil availability. This latter group of predominantly American companies has firmly rejected an offer price of around $30 and put in counter claims of between $32 and $33.50 depending on crude qualities. An attempt has been made by BNOC (including invoking the help of the US Administration) to urge the companies concerned to moderate their demands, but to no avail.

BNOC tell us that the weight of evidence that the free market price is around the $32 to $33 level is so strong that it is unrealistic to suppose that further Government pressure would serve any useful purpose. During the last week term supplies of oil from the USSR have been traded at prices in excess of $33, and Libyan oil has been resold, again on a term basis, at prices ranging from $38 to $40. BNOC judge that overt intervention by Ministers will provoke more determined opposition than in the past on the grounds that the terms of its participation agreements, which provide for prices to be determined as between a willing buyer and a willing seller, are being overriden. All the signs are that if BNOC does not increase its offer price to around $32 to $33 or itself call in an independent expert valuer, then the companies will themselves exercise their right to go to experts within the next few days.

There are effectively two options open to us:

(i) to authorise BNOC to go ahead and reach agreement on prices, recognising that they will almost certainly have to increase their offer price to around $32 to $33 to achieve a settlement (although this could be presented as a basic price

of, say, $29.75 for Forties crude plus a market related temporary surcharge)

i.e. arbitration

(ii) to invite BNOC to call in an expert valuer to settle 1st Quarter price levels.

Either course will result in a price for UKCS crude above the currently declared official price in Nigeria - though not above the price at which crude oil of this quality is actually being traded in world markets on a term basis. There must, therefore, be a risk that the UKCS crude price at this level will be used as a justification for an increase in the official price of African crudes, possibly including Algerian crude. (As you know BNOC's price increase will apply from 1 January in the usual way and there can be no complaints that this would be retrospective in an OPEC sense.)

i.e. BNOC have already notified their customers that prices go up from 1 Jan. TL

But since we are explicitly not in control of UKCS pricing decisions, there is little we can do to avoid this danger. The question for us is simply which of the two routes to a higher UKCS price is less objectionable and less damaging for our interests as an oil consumer. The option of going to an independent expert could help our interna-tion posture as a demonstration of our determination to try to set UKCS prices in the rearguard of current market levels. But BNOC believe that there is a very real risk in the light of current market developments that an expert valuer would come up with an even higher price than $32 to $33 which would, even if delayed by a week or two, be more likely to lead to leapfrogging increases by the African producers. The defence that BNOC had been forced there by an indepen-dent valuer would not in practice lessen the criticism we would face in those circumstances.

The alternative is therefore for BNOC to go ahead and reach agreement with its suppliers without resort to experts. The Corporation points out that to do so would be entirely consistent with the UK policy of following the market and would enable it to retain its credibility as a trading organisation while at the same time avoiding a potentially

awkward precedent for both itself and Government in future price negotiations. In doing so, BNOC would be ready to adopt the idea of offering any additional money in the form of a supplementary payment or surcharge on a basic price of $29.75 for Forties crude, although it believes that it would probably have to commit itself to any surcharge element for the whole of the 1st Quarter. There would nevertheless still be presentational value in putting up the offer price in a way which helped to reinforce the view that surcharges and premia are a temporary rather than permanent feature of the scene. It might also reduce the risk that the Nigerians and, more particularly, the Algerians who are also pricing from a $30 base, would find an excuse in UKCS prices for further increases in their own prices.

To sum up, I believe that the balance of advantage lies in allowing BNOC to seek agreement with its supplying companies without reference to independent experts. I recognise that it will be important for posts abroad and the press to be given firm guidance about the reasons for BNOC's actions, but we have put in a lot of groundwork and I believe that there is already evidence of greater understanding both at home and internationally of our position on prices. Unless you and other colleagues object, therefore, I propose to authorise BNOC to go ahead and negotiate agreement on prices on the basis outlined above. I believe we should do this by Wednesday lest the decision is taken out of our hands by BNOC's suppliers taking it to experts.

I am sending copies of this minute as before to the Foreign Secretary, the Chancellor of the Exchequer and to Sir Robert Armstrong.

DH.

SECRETARY OF STATE FOR ENERGY
14 January 1980

15 JAN 1980

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

9 January 1980

NORTH SEA OIL PRICES

The Prime Minister has now considered your letter of 4 January and your Secretary of State's minute of 3 January which you enclosed with it. She has also seen Martin Hall's letter of 7 January and Paul Lever's letter of 8 January.

Since the Nigerians have apparently not raised their prices above $30 a barrel, the Prime Minister agrees that BNOC should be authorised to establish a UKCS marker price at that level. The question of whether there should be a temporary surcharge on the $30 price is now hypothetical, and the Prime Minister does not wish to take a decision on this for the moment. Instead, she would like early advice on the pros and cons of the arbitration approach. She believes that there would be political advantage if North Sea prices were established under the terms of legally binding commercial contracts by recognised and independent arbitration procedures. On the other hand, the economic and financial implications of this approach need to be thoroughly considered.

I am copying this letter to Paul Lever (Foreign and Commonwealth Office), Martin Hall (H.M. Treasury) and to Martin Vile (Cabinet Office).

T. P. LANKESTER

Denis Walker, Esq.,
Department of Energy.

CONFIDENTIAL

Ref: A01088

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MR. LANKESTER

The Price of North Sea Oil

You asked for advice on the Secretary of State for Energy's minute of 3rd January to the Prime Minister, as supplemented by his Private Secretary's letter to you of 4th January, about the price of North Sea oil.

2. The Chancellor of the Exchequer has of course since commented through a letter from his Private Secretary to you dated 7th January. Sir Robert Armstrong has no reason to dissent from the joint view of the two Ministers that, given what appears to be the Nigerian decision, $30 a barrel is an acceptable price for the time being.

3. At the same time Sir Robert wonders whether it makes sense for the Government to get, or appear to get, involved in the price-fixing process. Not only does this attract unnecessary political flak from our European partners, but the cost of interference to restrain prices is potentially high (every cent on a barrel of North Sea oil raises the annual value of North Sea output by about $7 million, of which about three quarters ultimately comes to the Exchequer). Of course we can and do say that the British Government does not set the price of North Sea oil and that it simply follows the market. But our protestations would carry more conviction if it were clear that the price was established under the terms of legally binding commercial contracts by recognised and independent arbitration procedures.

4. Before deciding whether the political benefits of the arbitration approach are worth having, we should need to know what price tag, if any, might attach to them. How would an arbitrator's price be likely to compare at the margin with an administered price - particularly in the present confused state of the market? A judgment here must turn on detailed knowledge of the arbitration procedures and ground rules which we do not have. Sir Robert suggests that in replying to Mr. Howell's minute the Prime Minister should ask for considered advice on what the likely effect on our oil prices would be if we set out positively to encourage recourse to arbitration rather than, as at present, sought to avoid it.

MJV.

(M. J. Vile)

8th January 1980

Prime Minister

See Treasury and FCO comments at Flags A and B. Since the Nigerians have not increased their price above $30, BNOC should stick at this level. Before deciding on possible supplements for the future, it would seem worth examining the arbitration option as suggested below. Agree?

[illegible] 8/1

[illegible] As this would take time - we should go ahead with $30 - but more North Sea producers may think that is not enough. Perhaps advice on arbitration procedure could i.e. be prepared. Flag A [illegible]

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Foreign and Commonwealth Office

London SW1A 2AH

8 January 1980

Dear Michael,

North Sea Oil Prices

The Foreign and Commonwealth Secretary has seen the Secretary of State for Energy's minute of 3 January to the Prime Minister and Denis Walker's further letter to you of 4 January about North Sea oil prices. He agrees broadly with the approach that Mr Howell has proposed. We understand that there is still no hard evidence that the Nigerians have increased their prices above $30 per barrel. In these circumstances, Lord Carrington assumes that the authorisation to be given to BNOC will be on the lines of (a) in the Secretary of State for Energy's minute of 3 January.

If the Nigerians subsequently increase prices to around $34 per barrel, Lord Carrington sees some attraction in Mr Howell's suggestion that BNOC should pursue the idea of retaining a basic market price of around $30 per barrel, but adding on a temporary surcharge to be reviewed monthly. He attaches particular importance to the arguments set out in (b) of Denis Walker's letter of 4 January, and hopes that if we follow this course we can make it clear publicly that the surcharge is temporary and subject to regular review, and would be reconsidered if demand for oil falls this spring. We could present this internationally as evidence that the Government were seeking to influence market trends in a moderate direction.

Denis Walker's letter does not state explicitly that the temporary surcharge which his Secretary of State has in mind would be in the order of $2.75, to take the effective price up to the proposed ceiling of $32.75. No doubt the Department of Energy will confirm that that is what Mr Howell has in mind. A higher surcharge, even if labelled temporary, would be exceedingly difficult to defend internationally.

I am sending copies of this letter to Denis Walker (Energy), Martin Hall (Treasury) and Martin Vile (Cabinet Office).

Yours ever

Paul

(P Lever)
Private Secretary

M O'D B Alexander Esq
10 Downing Street

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

7th January 1980

Dear Tim,

NORTH SEA OIL PRICES

The Chancellor has seen a copy of the letter of 4th January from the Private Secretary to the Secretary of State for Energy about North Sea oil prices. The letter reported the Secretary of State's view that if Nigerian prices do not rise to above $30 per barrel, BNOC should seek to establish a single UKCS marker price at $30 per barrel. But if Nigeria moved to $34 per barrel, a UKCS price of around $32.75 per barrel would be defensible with perhaps the extra $2.75 being treated as a temporary supplementary payment or surcharge to be reviewed monthly.

The Chancellor understands that the Nigerians have in fact decided on a price of $30 per barrel and in these circumstances he would agree that BNOC should seek to establish a UKCS marker price at the same level. A higher price would increase PRT, etc. receipts and the PSBR would be reduced if our decision on oil prices did not affect world oil prices. But any price above $30 would be difficult to justify internationally in view of the Nigerian decision to stick at that price and it could well provoke the Nigerians into raising their prices to our level using our decision as an excuse. This would be embarrassing.

But if the Nigerians increased their prices above $30 within the quarter, we ought to reconsider UKCS prices. The Chancellor thinks that in those circumstances the Secretary of State's suggestion for a temporary supplement might be helpful presentationally.

The Chancellor has therefore concluded that this is not the moment to go for the highest possible price, for example in reply to the failure so far of the Community to meet us on our contribution to the Community Budget. If we wanted to consider that step, the time to do so would be after the next European Council if no progress was then made on the Budget.

/Finally,

T. Lankester, Esq.,
No.10, Downing Street

CONFIDENTIAL

Finally, the Chancellor thinks it most important that posts abroad and the press are given firm guidance about the reasons for and the reasonableness of our line.

I am sending a copy of this letter to Paul Lever (FCO), Denis Walker (Department of Energy) and to Martin Vile (Cabinet Office).

Yours ever,

(M.A. HALL)

2

Would it be a bad thing if we were taken to arbitration? — mb

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

01 211 6402

PRIME MINISTER

To see. You will want to have colleagues' reactions to these proposals. D. Energy tell us that the Observer will be running a story that the price is to be fixed at $33.

MS 4/1

Tim Lankester Esq
Private Secretary to the
Prime Minister
No 10 Downing Street

4 January 1980

Dear Tim,

Since writing the attached minute of 3 January to the Prime Minister, my Secretary of State has been giving further consideration prior to his departure this morning for the Middle East to the BNOC proposal for a 2-tier price if all the African producers increase their prices to around $34 per barrel.

He has asked me to say that he remains of the view that if Nigerian prices do not rise above $30 per barrel BNOC should seek to establish a single UKCS marker price at $30 per barrel.

If Nigeria does move to $34 per barrel, however, he believes that while a UKCS price of around $32.75 per barrel would be defensible, there are attractions in allowing BNOC to pursue the idea of retaining a basic marker price of around $30 per barrel with the addition of a temporary supplementary payment or surcharge to be reviewed monthly. If BNOC could secure acceptance of this idea it would:

(a) combine the virtue of a lower basic price while at the same time ensuring that the UK did not lose the balance of payments and revenue benefits of higher market prices; and

(b) by making the surcharge a temporary payment, subject to review each month, help to reinforce growing market sentiment that the very large surcharges and premia of recent months may not be a permanent feature of the scene particularly if the oil market slackens in the Spring.

My Secretary of State recognises that there could be criticism if the UK appeared to be adding to the recent welter of OPEC price premia and surcharges, but feels that the balance of advantage lies in allowing BNOC to act in a way which, while enabling it to meet its obligation to pay market prices, would nevertheless help to confirm the logic of and reinforce current market expectations by sticking to a low basic price and giving itself the flexibility to review any surcharge payment on a month-by-month basis.

My Secretary of State has accordingly asked me to suggest to the Prime Minister and to other ministerial colleagues that BNOC should be authorised to go ahead next week on this basis.

(2)

I am sending copies of this letter to Paul Lever (FCO), to Martin Hall (Treasury) and to Martin Vile (Cabinet Office).

Yours ever,

Denis

Denis Walker
Private Secretary

conqueror

PRIME MINISTER

Following the failure to reach agreement on prices at the OPEC Ministerial Conference in Caracas the Algerians and Nigerians followed the Libyan lead by raising their official selling prices to $30 per barrel from the middle of December. Since then the Libyans have increased their prices from 1 January by a further $3 surcharge, plus a retroactive premium of $1.72 to apply during the 1st Quarter of 1980. The Algerians have also announced a $3 surcharge for the 1st Quarter which may be returnable later to those engaging in approved exploration work. It was reported in the press yesterday that the Nigerians were also intending to raise the selling price to more than $34 for the 1st Quarter. But in spite of enquiries there is no confirmation of this. There are therefore still considerable market uncertainties which we must allow for in agreeing on BNOC prices for North Sea oil. There is also a possibility that later in the year the oil market may slacken.

The light African crudes effectively establish the market price for North Sea crudes. BNOC, which is required to pay the going market rate for the oil it purchases under participation agreements, is now coming under very strong pressure from supplying companies to adjust its prices to new market levels. If the Nigerian move is not confirmed then it would be difficult to agree a price for UKCS crude in excess of $30 although this could involve a risk of challenge at arbitration. If a Nigerian move to around $34 is confirmed, then it could justify a figure of about $32.75 which we might be able to hold for some time without challenge. It would be intended to be slightly under the average African term price and the figure an independent valuer might set at arbitration.

BNOC believe in the present very uncertain outlook for oil prices and assuming a Nigerian price increase that there could be both presentational and practical advantages in quoting a basic price of around $30, but to propose in addition a temporary supplementary payment or surcharge to be reviewed monthly. On the whole however I think that there would be an advantage in sticking to a single price for the time being.

This would avoid complaints that we were following recent OPEC practices which have aroused so much criticism.

BNOC has notified all its suppliers and customers in the usual way of a price change to be effective from 1 January and there can be no complaints that the 1st Quarter price determination will be retrospective in an OPEC sense.

Given all the present uncertainties it is not possible to come to a firm view on what North Sea price we should seek to establish or precisely when we should move. But if there are no other new factors, and if you and other colleagues see no objection, I suggest we authorise BNOC to go ahead and reach agreement next week on one of the two following bases:-

(a) if Nigerian prices do not rise above $30 per barrel, BNOC should seek to establish the basic North Sea price at $30 per barrel. This would be clearly defensible as showing moderation in the face of the significantly higher prices being charged by Libya and Algeria. There would however be a risk of BNOC being taken to arbitration (which might take two or three weeks) and the price being forced up as a result.

(b) If Nigeria does move to $34 then the UKCS prices should be based on $32.75. Again this would be defensible as moderate, given that the average market level for relevant African crudes would be above this, but it should not attract challenge at arbitration and would help to ensure that the UK did not lose the balance of payments and revenue benefits of higher market prices.

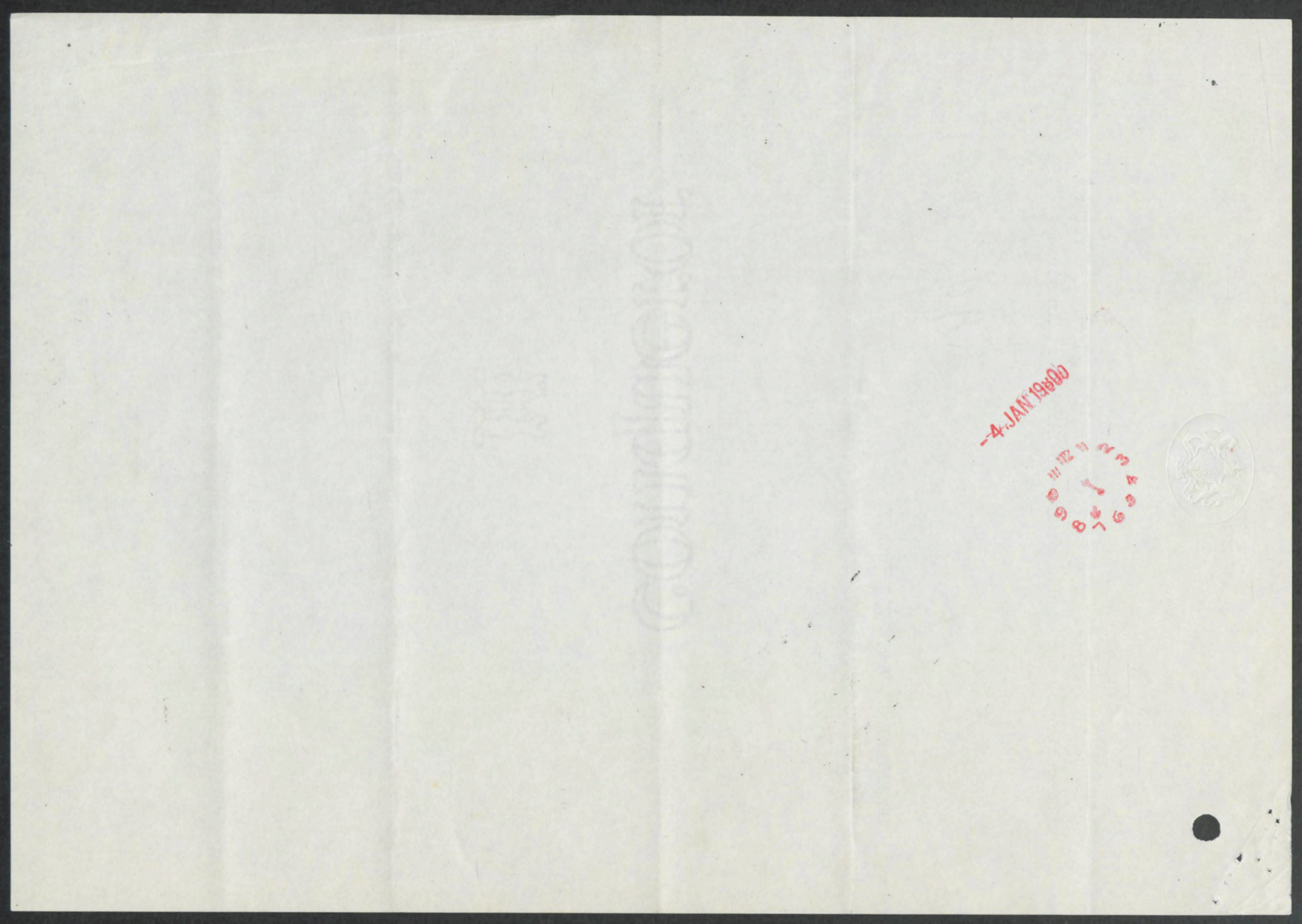
I have taken into account the views likely to be expressed by our EEC partners and by the USA on what is both a problem and a very sensitive issue: but I am confident that on either basis we can make a good case for saying that we have acted with moderation and consideration for their views if that is the line of general policy we want to pursue.

I am sending copies of this letter to the Foreign Secretary, the Chancellor of the Exchequer and to Sir Robert Armstrong.

DH.

SECRETARY OF STATE FOR ENERGY
3 January 1980

conqueror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