PREM 19/1737

SECRET

North Sea Oil Prices.

Heavy Fuel Oil Prices + World Oil Market

PREM 19/1737 Pt 2

ENERGY

Part 1: January 1980

Part 2: October 1983

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
2.10.83		23.8.84		13.2.85		16.12.85	
2.11.83		21.9.84		11.2.85.		10.1.86	
20.1.84.		24/9/84		25.2.85		15.1.86	
25.1.84		28.9.84		1.3.85		22.1.86	
26.1.84		9.10.84		11.3.85		23.1.86	
6.2.84		17.10.84		3.4.85		27.1.86	
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1.6.84		29.10.84		2.5.85		29.1.86	
13.6.84		9.11.84		6.5.85		31.1.86	
10/7/84		14.12.84		24.5.85			
20.7.84		21.12.84		30.5.85		ENDS	
3.8.84		4.1.85.		7.6.85.			
10.8.84		7.1.85		28.6.85			
15.8.84		10.1.85.		18/7/85			
17.8.84		15.1.85		26.7.85			
		17.1.85		13.9.85			
		23/1/85.		20.9.85.			
		24.1.85		25.9.85.			
		30.1.85		25.9.85			
		31.1.85		26.9.85			
		5.2.85		2.10.85			
		9.2.85		30.10.85			
				10.12.85			
				12.12.85			

PART 2 ends:-

FCO to Energy 31.1.86

PART 3 begins:-

Vienna Tel 18 4.2.86

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(85) 36th meeting, item 4	12/12/1985
CC(86) 3rd meeting, item 4	23/01/1986

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 _____ Date 22/09/2014

PREM Records Team

010

30

Foreign and Commonwealth Office

London SW1A 2AH

31 January 1986

Dear Geoff,

WITH DN

Oil Prices

Thank you for sending me a copy of your letter of 27 January to Rachel Lomax.

Ever since the initial Formal Understanding for the purchase of Tornado was signed last September we have been on the lookout for signs that the Saudis might link the purchase of these aircraft to our willingness to accommodate Saudi concerns over oil. Although the Saudis have had several opportunities to make this linkage, they have never done so. It was not raised, for example, when Sir Geoffrey Howe called on the King and the Foreign Minister earlier this month; and Shaikh Yamani's attitude to a meeting with Mr Walker suggests that the Saudis are in fact more critical of us in public than in private, an argument our Ambassador elaborated on in his telno 81 of 27 January.

The Tornado deal itself appears to be making satisfactory progress. It is noticeable that the oil deal was signed with Shaikh Yamani on 26 January - ie after the King is alleged to have stated his intention to get tough with the UK.

Against that background we do not believe that Mr Wyatt's warning should cause too much alarm. We should certainly not be complacent about the Saudi attitude, which could harden towards us if prices continue to fall sharply. Our Embassy in Riyadh will watch for any sign of such a change in Saudi thinking. But as far as Tornado is concerned, the Foreign Secretary believes we should keep a steady nerve.

Mr Wyatt is known to us as a prominent businessman. We have no information on how close he is to President Reagan or on his reliability as an interlocutor, but we are making enquiries through our Consulate-General in Houston.

/I

SECRET

I am copying this letter to David Norgrove (No 10), John Mogg (DTI), Richard Mottram (MOD) and Rachel Lomax (Treasury).

Yours ever,

Robert Culshaw

(R N Culshaw)
Private Secretary

Geoff Dart Esq
PS/Dept of Energy

31. I.
PM 8 6

10 DOWNING STREET

Ronnie Hunter

This accords with Dr Hammer's view.

It also points to action to keep energy prices up in the UK through taxation — we already have a poor record on efficient use of energy.

DLW
31/1

MR NORGROVE

31 January 1986

IMPACT OF LOWER OIL PRICES ON UK OIL AND GAS DEVELOPMENT

In recent years investment in the development of our oil and gas resources has represented roughly 25% of total UK industrial investment. The UK content of the expenditure has been over 70%, generating many thousands of jobs. With oil prices less than $20 per barrel, should we now brace ourselves for a hiatus of exploration and development activity? My guess is no.

The oil industry has polarised into two cultures. The buyers and traders on the downstream side of the industry have become very short term in their outlook, living on their wits in response to the hour-by-hour movement of oil prices. By contrast, those on the upstream side of the industry are preoccupied with the outlook for energy prices in the 1990s, when the oil and gas fields currently being planned and developed will come into production. Today's oil prices make them nervous, but they take comfort in the underlying trends.

Three-quarters of the non-communist world's known oil reserves are in OPEC countries - dominantly Saudi Arabia, Iraq, Iran, and Kuwait. Yet the rate of non-OPEC production is currently twice that of OPEC. Each year the world consumes the equivalent of the original North Sea oil reserves, but today there are no newly-found provinces like the North Sea ready to be developed. Non-OPEC production is set to decline before

long - the more so if oil prices remain low in the short term. It seems inevitable that the OPEC countries will be back in the driving seat some time in the 1990s; the only question is when.

Against that background, let me be more specific as regards UK oil and gas activity:

- The existing oil fields will continue to produce because marginal operating costs are generally less than $5 per barrel, and in any event the facilities must be maintained.

- The producing gas fields are dedicated to BGC under long-term contracts; in any case, the contract prices for the gas are largely uninfluenced by oil prices.

- The oil and gas fields already under development will be brought into production as planned; for those approaching completion, there is a compelling case to press ahead and start generating cash; for those not long started, the hope is that oil prices will be higher when the fields come into production in a few years time.

- For development projects currently being planned, the key question is oil prices in the 1990s, ie the picture outlined above. As regards new gas

development projects, BGC needs the gas so there is a sellers' market.

At heart upstream oil men are optimists. Moreover, when the going is tough they would rather be investing in the UK North Sea than most other places. I don't believe we shall see much slackening of momentum, either of exploration or development.

JOHN WYBREW

SECRET

Price Review 2 29

I imagine that stories like this may sooner or later begin to reach the newspapers.

DLS 31/1

Jp.0120

Mr Norgrove

c: Mr Powell (with attachments)

Oil Prices

Geoff Dart's letter attached.

It is also worth noting that Sheikh Yamani signed the Tornado oil contract the day after the King is said to have made these remarks. However, the Saudis do face a very difficult balance of payments outlook over the next few years and they will be looking for substantial savings on their imports. The Tornado deal may be at risk on this account. We shall be looking at the Saudi economic outlook and their policy options in more detail in a forthcoming assessment.

PERCY CRADOCK

31 January 1986

THIS IS A COPY. THE ORIGINAL IS RETAINED UNDER SECTION 3 (4) OF THE PUBLIC RECORDS ACT

SECRET

820

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

CONFIDENTIAL

01 211 6402

Has seen CDP 31/1

Prime Minister

You will want to read this before your telephone call from Mr. Lubbers at 11.00

CDP 31/1

Charles Powell Esq
Private Secretary to the Prime Minister
10 Downing Street
London
SW1

31 January 1986

Dear Charles,

OIL PRICES

I understand that the Dutch Prime Minister is expected to telephone the Prime Minister to express his concern at the effect of falling oil prices on Dutch gas revenues. He may propose a Community initiative on oil prices.

The background to Dutch concern lies in the link between gas and oil prices. Approximately 15% of Dutch Government revenue derives from sales of natural gas, and, as you know, the Lubbers Government faces the prospect of an early election. I understand that, following statements in a recent Parliamentary debate about the need for an EC initiative, the Dutch Energy Minister, Dr Van Aardenne, may be planning to raise this at the Energy Council scheduled for 10 February. It goes without saying that any such public discussion would be unwelcome, and counter-productive.

I am copying this to Colin Budd in Sir Geoffrey Howe's office.

Yours ever,

G S DART
PRIVATE SECRETARY

CONFIDENTIAL

BRIEF FOR THE PRIME MINISTER

Call by Prime Minister of the Netherlands

OIL PRICES AND PRODUCTION LEVELS

1 We have been watching developments in the oil market closely. The determination of Saudi Arabia to abandon its role as swing producer and to increase production has put serious downward pressure on prices.

2 Prices are determined by the market and we cannot over-rule market trends. World oil demand has declined by almost 10 million barrels per day to around 45 mbpd since 1979, and there is now considerable surplus production capacity.

3 UK production levels are determined by producers not HMG (subject only to technical restrictions to protect the oil reservoirs). No intention of changing our policy or considering arbitrary cuts in production.

4 See no role for the Community in trying to influence oil market. And speculation about possible community action will only further unsettle an already nervous market. Nor would there be consensus between member states, many of whom are major oil consumers, on which way to influence the market. Appreciate concern over lost revenues but need to look to the wider economic benefits. The effects of lower oil prices on the UK economy are broadly neutral or possibly slightly beneficial.

5 Nor do we see any advantage in formal or multilateral discussions between oil producers and consumers. This would only raise false expectations and possibly confrontation. We are making clear in all our contacts with OPEC Ministers that there has been no change in our policy on production levels. (If pressed: contrary to press reports, the Energy Secretary has not had any meeting with Yamani.)

6 (Defensive). South Africa. Our oil distination guidelines have precluded the export of oil to South Africa since 1979. Our policies therefore fully accord with the Luxembourg agreement. The UK does not import oil simply for re-export so there is no practical problem over oil in free circulation.

Background

1 The Dutch are major gas exporters to Europe. Net gas exports amounted to 3.4% of Dutch GDP, a higher proportion than represented by UK oil exports (2.9% of GDP). Their revenues are probably as dependent on petroleum taxes as ours. The price of Dutch gas is tied to oil prices, accordingly their revenues have been directly affected by the fall in world prices.

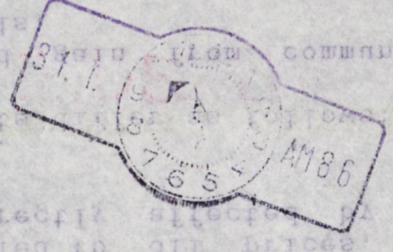
2 Dutch and UK interests differ as follows:

(i) they would gain from community protection of non-oil fuels;

(ii) their balance of payments would benefit from lower world oil prices;

(iii) capital unit costs of onshore Dutch gas production are minute compared to our offshore oil production. They would therefore be much less concerned about the deterrent effect on future development of production constraints.

3 The Dutch are currently President of the Community and may want to promote a Community initiative on the oil market. However, we succeed them as President at the end of June and we both wish to co-operate in the interests of continuity of Community business. They are less likely to press an initiative in the face of UK opposition.



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FROM THE HAGUE
TO DESKBY 301830Z FCO
TELNO 072
OF 301740Z JANUARY 86
AND TO IMMEDIATE DEPARTMENT OF ENERGY
INFO IMMEDIATE UKREP BRUSSELS
INFO ROUTINE ALL EC POSTS

→ Charles Powell
(No. 10)

Prime Minister
We think this is one of the problems which Mr. Lubbers wants to discuss with you on the telephone tomorrow.
CM.

TELECON BUDD/PAUL: DUTCH CONCERN ABOUT THE WORLD OIL MARKET

SUMMARY

1. THE NETHERLANDS GOVERNMENT IS GREATLY CONCERNED ABOUT THE IMPLICATIONS OF THE FALL IN OIL PRICES. IN ADDITION TO NATIONAL MEASURES TO MEET THE EXPECTED SHORTFALL IN REVENUE, THEY ARE ALSO CONSIDERING WHAT CAN BE DONE AT AN INTERNATIONAL LEVEL, AND POSSIBLY IN AN EC FRAMEWORK TO STABILIZE THE MARKET. THEY MAY WELL RAISE THIS AT THE ENERGY COUNCIL ON 10 FEBRUARY.

DETAIL

2. IN A DEBATE IN THE SECOND CHAMBER ON 28 JANUARY, FOLLOWING AN EMERGENCY CABINET MEETING TO CONSIDER WHAT MEASURES SHOULD BE TAKEN TO COUNTER THE FALL IN GOVERNMENT REVENUE ARISING FROM THE DROP IN OIL PRICES, LUBBERS PROMISED INTER ALIA ACTION BY THE EC. LATER , A GOVERNMENT SPOKESMAN SAID THAT MR VAN AARDENNE, THE MINISTER OF ECONOMIC AFFAIRS, WOULD ADVOCATE ACTION TO ACHIEVE OIL MARKET STABILITY AT THE ENERGY COUNCIL ON 10 FEBRUARY. THE SPOKESMAN COMMENTED: ''IT IS NOT JUST A QUESTION OF TALKS WITHIN THE COMMUNITY ALTHOUGH BRITAIN IS PARTICULARLY IMPORTANT AS A LEADING OIL PRODUCER OUTSIDE OPEC. THERE MAY ALSO BE A ROLE FOR THE COMMUNITY IN BRINGING TOGETHER OPEC AND NON-OPEC PRODUCERS.''

3. WE HAVE SPOKEN TO CONTACTS IN THE PRIME MINISTER'S OFFICE AND THE MINISTRY OF ECONOMIC AFFAIRS TO TRY TO FIND OUT MORE ABOUT LUBBERS' THINKING. BOTH OUR INTERLOCUTORS CLAIMED THAT THE GOVERNMENT HAD NO CONCRETE IDEAS FOR ACTION BY THE EC, BUT THE MEA SPOKESMAN COMMENTED THAT THERE WAS SOME DISAPPOINTMENT IN OFFICIAL CIRCLES THAT THE BRITISH GOVERNMENT, AS A MAJOR OIL PRODUCER, SEEMED UNWILLING TO TALK TO OPEC PRODUCERS ABOUT POSSIBLE MEASURES TO STABILISE THE MARKET.

4. THE NETHERLANDS GOVERNMENT HAVE PARTICULAR CAUSE FOR CONCERN OVER THE FALL IN OIL PRICES. GAS PRICES ARE OF COURSE AFFECTED BY OIL PRICES, AND 15% OF THE GOVERNMENT'S REVENUE IS DERIVED FROM THE SALE OF NATURAL GAS (ABOUT DF123 BILLION IN 1985)

AARDENNE, THE MINISTER OF ECONOMIC AFFAIRS, WOULD ADVOCATE ACTION TO ACHIEVE OIL MARKET STABILITY AT THE ENERGY COUNCIL ON 10 FEBRUARY. THE SPOKESMAN COMMENTED: ''IT IS NOT JUST A QUESTION OF TALKS WITHIN THE COMMUNITY ALTHOUGH BRITAIN IS PARTICULARLY IMPORTANT AS A LEADING OIL PRODUCER OUTSIDE OPEC. THERE MAY ALSO BE A ROLE FOR THE COMMUNITY IN BRINGING TOGETHER OPEC AND NON-OPEC PRODUCERS.''

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MARGETSON

29 January 1986

I checked the position on oil exports following our conversation at lunch on Monday.

Net oil exports are 8 percent of total UK exports. Gross oil exports are 15 percent of total exports.

(DAVID NORGROVE)

Sir David Wolfson
8 Douro Place, W8

CONFIDENTIAL

CPRS (2)

Prime Minister

CDP
29/1

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

Len Appleyard Esq
Private Secretary to
The Foreign & Commonwealth Secretary
Whitehall
LONDON SW1

29 January 1986

Dear Len,

My Secretary of State had a brief meeting with Dr Al-Otaiba, the United Arab Emirates' Oil Minister on the afternoon of 28 January. The Minister of State, Mr Guinness and two UAE officials were also present.

The discussion followed predictable lines. Dr Otaiba said that he was passing through London on the way to Vienna for Monday's OPEC meeting, and was glad of the opportunity to exchange views with Mr Walker. He was not here to negotiate with the UK on OPEC's behalf. Mr Walker said that he was always prepared to meet other energy Ministers, and found such contacts helpful.

Dr Otaiba said that the current oil market situation was worrying. The market was volatile and difficult to control or predict. It was in no-one's interest for the oil price to collapse; all producers were either "friends or brothers" and should co-operate to stabilise production. Egypt had decided to cut production by 200,000 bpd. Russian production was falling. Iran had offered to cut its production, and among the non-OPEC producers Norway and Oman had indicated willingness to join in collective action. If no action were taken, he feared a continuing downward price spiral as producers stepped up output to maintain their revenues.

Mr Walker said that the Norwegians had made it clear that their position and policies remained unchanged. The UK was in favour of reasonable price stability, and wished to maintain our close and friendly ties with the UAE and other OPEC nations. But our perspective was bound to be different from OPEC's; oil accounted for only 6% of our national income and there were very substantial compensations for us in lower oil prices. UK production was probably now at or about its peak. Our best estimate was that 1986 production would be similar to 1984 and 1985 at about 2.5 to 2.6 mbd, although it was impossible to be precise about the outcome of decisions by a large number of individual producers. Thereafter our production, and our influence - which had been greatly exaggerated - would be sharply reduced. The main factor influencing the market was not the UK's policies but increased production by Saudi Arabia.

CONFIDENTIAL

Mr Walker went on to explain that the heavy front-end loading of North Sea investment meant that it was economic for production to continue even at very low levels. The UK Government had consistently made it clear that it could not and would not impose production cuts on the oil companies. Nor did it put pressure on the companies to maximise production; the level of production was entirely a matter for their individual commercial judgements. Any attempt to interfere with the companies' commercial freedom would be likely to impact badly on the UK's reputation as a major trading nation and thus on future investment, and might cause difficulties with our international trading partners, particularly in the EC.

In reply to a question from Dr Otaiba, Mr Walker said that it was impossible to predict the likely oil price path. There was no mechanism which could guarantee a stable price of X or Y dollars. Dr Otaiba said that he believed the US would not wish to see the price fall below about $20, in view of the vulnerability of the banking system.

The Secretary of State asked Dr Otaiba about the likely outcome of the Vienna meeting. Dr Otaiba said that it was difficult to predict. Saudi views would be crucial, but his guess was that a more relaxed production ceiling of 18 mbpd would be agreed. He would telephone Mr Walker after the meeting to let him know what had been decided. Mr Walker could also expect to hear from the Omanis, who were now convinced of the need for all producers to co-operate.

I am copying this letter to David Norgrove (No 10), Rachel Lomax (Treasury) and John Mogg (DTI).

Yours,

Geoff

G S DART
Private Secretary

PM 8 6

010

CC BG

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

G S Dart Esq
Private Secretary to the
Secretary of State for Energy

28 JANUARY 1986

Dear Geoff,

OIL PRICES

Thank you for your letter of 27 January.

The Chancellor does not recall ever meeting Mr Oscar Wyatt.

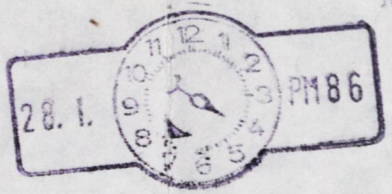
Even assuming Mr Wyatt's information is correct, the Chancellor remains of the view that the Government should hold to its longstanding policy of non-intervention in UKCS production levels.

I am copying this letter to David Norgrove (No 10), Len Appleyard (FCO), John Mogg (DTI) and Richard Mottram (MOD).

Yours ever

Rachel

RACHEL LOMAX
Principal Private Sectetary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PM 8 6

BR/4

DN Hay
Seen.

FROM: MRS R LOMAX
DATE: 28 JANUARY 1986

MR VERNON

1 - Nigel - pl
Copy to David Norgrove - No 10

2 - pm

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Cassell Mr Lavelle
Mr Monck
Mr Evans
Mr Fitchew
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr Robson
Miss O'Mara

OIL SUBJECT BRIEF

The Chancellor was grateful for the revised version of this subject brief, attached to your minute of the 28 January. On defensive 5, he has commented that while the facts are no doubt correct, we do not want to appear as spokesman for the oil companies.

RL

RACHEL LOMAX

29. I.
AM 36

TF

MR NORGROVE – No 10.

David,

We spoke – for your own use. Some good material here.

Philip WS.

28/1

14-25

FROM: K VERNON
DATE: 28 JANUARY 1986

1. MISS O'MARA MOM 28/1

2. CHANCELLOR OF THE EXCHEQUER

cc Principal Private Secretary
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr Byatt
Mr Cassell
Mr Lavelle
Mr Monck
Mr Evans
Mr Fitchew
Mr Monger
Mr Scholar
Mr Culpin
Mr Kelly
Mr Mowl
Mr Robson
Mr Haache
Ms Leahy
Mr Pickering
HE/17

OIL SUBJECT BRIEF

I attach a revised version of this subject brief reflecting your comments contained in paragraph 4 of Mrs Lomax's minute of 27 January to Mr Broadbent. Specifically -

(a) a new defensive point 5 explaining why petrol prices have fallen by much less than crude prices

(b) Defensive point 8 makes the point more forcibly that we will not join OPEC.

(c) Defensive point 2 refers to FSBR forecast rather than the Autumn Statement.

(d) Factual 1 makes the point that the Autumn Statement assumption on oil prices was in line with the then prevailing oil price.

MOM

for K VERNON

273/011

North Sea Oil Brief

Factual

1. Prices: per barrel of North Sea crude for immediate delivery:

	$	£
average 1979	20.6	9.7
1980	34.7	14.9
1981	37.3	18.4
1982	32.9	18.8
1983	29.3	19.3
1984	28.8	21.3
1985	27.6	21.5
March 1985	28.0	24.9
November 1985	29.7	20.6
2 January 1986	25.8	17.7
22 January 1986	20.0	14.3

North Sea oil prices in $ terms currently about 20 per cent below forecast for 1986 which underlay Autumn Statement.

(IF PRESSED: Forecast underlying AS assumed $25 barrel for 1986, in line with then prevailing forward price, compared with current price of about $20. Also assumed $/£ exchange rate broadly unchanged at its October/November level. Current $/£ exchange rate is slightly below October/November 1985 level. See Defensive 1.)

Oil price in 1974 just under $10. Real world price, taking 1980 as 100, now 72 - lowest since 1979 - compared with 58 in 1974.

2. Tax revenues:

1984-85 - about £12 billion
- about 9 per cent of total revenues

1985-86 - about £11½ billion
- about 8½ per cent of total revenues
- largely determined by prices up to end 1985 so little affected by latest fall

1986-87 - estimate will be published at Budget time (but see also Defensive 2.)

3. Contribution of oil to the economy in 1985:

- 5-6 per cent of UK national income
- net oil exports 8 per cent of total UK exports (15½ per cent gross)
- 6 per cent of world oil production
- under ½ per cent of total UK employment
- 5 per cent of UK capital investment

4. Contribution to GDP growth

North Sea oil has contributed under ½ per cent a year to the average growth rate of economy of about 3 per cent a year during current upswing [1981H1-to date]. It contributed about 1 per cent a year in the upswing of 1975-79.
[NB has contributed ½ per cent a year since 1979, compared with annual growth of 1¼ per cent.]

Positive

1. Use made of North Sea revenue

(i) Overseas debt of public sector accumulated in 1970s reduced;

(ii) Revenues help reduce Government borrowing as a share of GDP and so help bring inflation down. Lower inflation good for investment. Domestic fixed investment across whole economy expected to beat record levels in 1985;

(iii) Build-up in net overseas assets to estimated £73½ billion end-1984, post-1945 record. Overseas assets will provide continuing foreign exchange income in future, as oil production declines.

2. Better off with North Sea oil

At today's prices, cost of extracting it below cost of buying oil on world market. And Government shares in profits of North Sea.

3. Beneficial effects of lower oil prices

Consumers and industry will benefit from lower oil prices. And lower prices will encourage higher world trade and output, with lower world inflation. The overall effects on both output and inflation in the UK are expected to be broadly neutral - if anything, slightly beneficial.

4. Effects of oil price falls on RPI?

Since May petrol prices at the pump have fallen by about 12p a gallon, or about 5 per cent. (A 10 per cent fall in pump prices reduces the level of the RPI directly by about ½ per cent, other benefits from lower energy prices.) [See Defensive 5.]

Defensive

1. Effect of lower prices on Autumn Statement 1985-86 revenue forecast

Oil price falls come too late in financial year to have much effect on 1985-86 revenues.

2. Effect on 1986-87 revenues of price fall

FSBR forecast North Sea revenues of £11½ billion in 1986-87. For latest estimate wait for Budget. $1 fall in oil price, other things being equal, equivalent to £500 million reduction in oil revenues. [NB oil price and exchange rate assumptions underlying FSBR forecast never made explicit.] But -

- consumers and industry would benefit from lower oil prices;
- lower prices would permit higher world trade and output, with lower world inflation

3. Ready reckoner

Suggests that other factors remaining unchanged, particularly the exchange rate, a fall in the oil price of $1 a barrel will lead to a reduction in revenues of £½ billion in 1986-87.

4. Effect of lower prices on PSBR

No decisions yet taken on appropriate level of PSBR for 1986-87. Government will persist with fiscal and monetary policies aimed at controlling inflation.

5. Oil prices down over 30 per cent but fall of only 5 per cent in petrol prices since May 1985 implies dramatic improvement in oil company margins

Why defend the oil companies?

Margins have improved in short term but petrol prices react to changes in crude prices only after a lag. They will not therefore reflect most recent fall in crude prices. Also, crude oil represents under half pump price of petrol, so would expect a much smaller change in petrol prices.

6. Effect of oil price falls on exchange rate

Markets naturally disturbed by recent large falls in oil prices. But actual relationship complex and uncertain.

7. Effect on North Sea activity

Oil prices would have to fall very far - well into single figures - for there to be any significant effect on production from existing fields. Exploration and development depend on price expectations, often looking very far ahead, and most analysts expect real oil prices to rise in the 1990s.

8. **Government curbs on North Sea production if oil prices start falling?**

UK continues to maintain freest oil province in world: decisions on how much to produce are made not by Government but by oil companies. We can take lower oil prices in our stride - some OPEC members, heavily dependent on oil exports, will suffer much more. There is no way in which UK will become country member of OPEC.

9. **GDP growth since 1979 simply reflects higher oil output**

In upswing - 1981H1 to 1985H1 - oil has accounted for less than ½ per cent of annual growth of around 3 per cent (contributed around 1 per cent in previous recovery).

G Haache, EA2 (Ext 3871)

SECRET

2716.

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COPY No 2 OF 7

Perry Gordon.

01 211 6402

Mrs Rachel Lomax
Private Secretary to
The Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON
SW1P 2AG

27 January 1986

Dear Rachel,

OIL PRICES

Officials in the Department have been approached by Anthony Towell, Chairman of Challenger International (a small UK publicly quoted oil company), who was formerly with Shell, at the request of Mr Oscar Wyatt to pass some information to the Secretary of State and the Chancellor. I understand that Mr Wyatt is Chairman of Coastal Corporation (a large US company) as well as a director of Challenger International. Mr Wyatt claims to be a close friend of President Reagan, and also says he knows the Chancellor, whom he tried to telephone direct.

Mr Wyatt wanted Ministers to know that he had just been told by a senior official in the US Government that the King of Saudi Arabia had said two days ago that unless the North Sea producers were willing to concert their policies with OPEC, he was intending to get really rough with Britain and Norway. The King had sought advice from his officials as to what punitive action Saudi Arabia could take against the UK in particular. He had raised the possibility of cancelling the Tornado contract and imposing tariffs on UK exports to Saudi Arabia.

Mr Towell was referred to the Department by Sylvan Robinson, who is head of Shell's worldwide trading activities and who has been leading for Shell in the Tornado negotiations. We do not know Mr Wyatt. I would therefore be most grateful for any light you or the FCO could throw on him.

I am sending copies of this letter to David Norgrove (No 10), Len Appleyard (FCO), John Mogg (DTI) and Richard Mottram (MOD).

Yours ever,

G S DART
Private Secretary

ADVANCE COPIES 28

OIL

PS
PS/MR EGGAR
PS/PUS
MR BRAITHWAITE
MR GOODALL
MR O'NEILL
MR DAVID THOMAS
Sir D. Miles.

HD/ESSD
HD/WAD
HD/ERD
HD/ECONOMIC ADVISERS
HD/MCAD
HD/MED
HD/SEAD
HD/NENAD

SENT 27 JAN 1986

PS/NO 10 DOWNING STREET
MR C E HENDERSON, (Hd. OIL Div. Room 1445 } DEPT OF ENERGY
MR ARNOTT } THAMES HOUSE SOUTH
MR RICKETT }
MR FREMANTEL }
PS/ S of S FOR ENERGY }

MISS P LEAHY HM TREASURY

MR R MARTIN, Rm 116 }
MISS LACKEY WEG } DTI (Victoria St)
MR D FORD CT5 }

ADVANCE COPY
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FM RIYADH
TO IMMEDIATE FCO
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OF 271030Z JANUARY 86
INFO PRIORITY ABU DHABI, ALGIERS, BAGHDAD, CARACAS, DOHA, JAKARTA
INFO PRIOTITY LAGOS, LIBREVILLE, QUITO, TEHRAN, TRIPOLI, KUWAIT
INFO PRIORITY DUBAI, MUSCAT, BAHRAIN, WASHINGTON, TOKYO, OSLO
INFO PRIORITY MEXICO CITY

MY TELNO 75: OIL PRICES.

1. WHEN I SAW YAMANI ON 26 JANUARY FOR THE SIGNATURE OF THE TORNADO OIL AGREEMENT, HE REMARKED THAT OPEC WAS NOW PRODUCING MORE THAN 17 MBD. IF THIS CONTINUED, HE EXPECTED THAT BY THE END OF MARCH THERE WOULD BE A 2.5 MBD SURPLUS OF SUPPLY OVER DEMAND, EXERTING FURTHER STRONG DOWNWARD PRESSURE ON THE MARKET. (HE REFERRED SPECIFICALLY TO A VERY RECENT IRANIAN AGREEMENT TO SUPPLY ADDITIONAL QUANTITIES TO JAPAN, BUT NONE OF US HAD AT THAT POINT SEEN REPORTS OF AN ALLEGED 50% CUT IN IRANIAN PRODUCTION.) HE BELIEVED THE OIL PRICE WOULD GO DOWN TO BELOW DOLLARS 15 PER BARREL.

2. ACCORDING TO THE US EMBASSY, YAMANI TOLD DEPUTY ASSISTANT SECRETARY OF STATE WENDT LAST WEEK THAT THE OIL PRICE WOULD HAVE TO GO DOWN FURTHER BEFORE OTHER PRODUCERS WOULD CO-OPERATE WITH SAUDI ARABIA AND CONTROL PRODUCTION IN SUPPORT OF THE PRICE. IN SPITE OF SAUDI PUBLIC STATEMENTS, HOWEVER, YAMANI SEEMED TO THE AMERICANS TO BE MORE CRITICAL OF OTHER OPEC COUNTRIES THAN OF BRITAIN OR OTHER NON-OPEC PRODUCERS. THIS IS IN LINE WITH THE ATTITUDE THE SAUDI DEPUTY MINISTER FOR OIL TOOK IN CONVERSATION WITH MY HEAD OF CHANCERY ON 20 JANUARY, WHEN HE IMPLIED THAT FRUSTRATION WITH OPEC HAD BEEN THE MAIN FACTOR BEHIND LAST AUTUMN'S CHANGE IN SAUDI OIL POLICY TOWARDS THE CONCLUSION OF NETBACK AGREEMENTS (GREEN'S MINUTE OF 20 JANUARY, COPIED TO FCO, DEPARTMENT OF ENERGY AND CHANCERIES BAGHDAD AND KUWAIT).

3. WE CAN NEVERTHELESS EXPECT SAUDI PUBLIC STATEMENTS TO CONTINUE TO CONCENTRATE ON THE SUPPOSED INIQUITIES OF NON-OPEC PRODUCERS, PARTICULARLY BRITAIN. YAMANI'S PRIVATE POSITION, AS I UNDERSTAND IT, CONTINUES TO BE THAT HE NEEDS SOME DEGREE OF CO-OPERATION FROM NON-OPEC PRODUCERS AS A LEVER TO USE WITH OPEC PARTNERS (MY TELNO 200 OF 6 NOVEMBER, PARA 4, REFERS). IN THE MEANTIME, THE SAUDIS SEEM LIKELY TO ACCEPT A CONTINUES EROSION OF THE OIL PRICE. THEY HAVE NO DOUBT CALCULATED THAT THE KINGDOM WOULD BE NO WORSE OFF EXPORTING OIL AT ITS CURRENT RATE OF ABOUT 4 MBD BELOW DOLLARS 15 PER BARREL THAN IT WOULD BE IF IT

WOULD BE NO WORSE OFF EXPORTING OIL AT ITS CURRENT RATE OF ABOUT 4 MBD BELOW DOLLARS 15 PER BARREL THAN IT WOULD BE IF IT EXPORTED 1 MBD (AS IT DID LAST SUMMER) AT LAST SUMMER'S PRICE.

4. WE HAVE HAD INDICATIONS THAT THE KING HAS NOT BEEN HAPPY WITH SOME OF YAMANI'S RECENT PUBLIC STATEMENTS, BECAUSE OF THE VULNERABILITY OF THE SAUDI ECONOMY TO LOSS OF OIL REVENUE IN A MARKET WHICH YAMANI HAS BEEN TALKING DOWN. ONE OR TWO SAUDI CONTACTS HAVE SUGGESTED THAT YAMANI HAS HAD SUCH A DIFFICULT TIME WITH HIS SENIORS OVER THE PAST TWO YEARS THAT IFT NO LONGER WORRIES HIM THAT HE MIGHT TALK HIMSELF OUT OF HIS JOB. IF TRUE , AND IT IS NOT IMPLAUSIBLE, IT ADDS A FURTHER ELEMENT OF VOLATILITY TO THE PRESENT SITUATION. HE CERTAINLY LOOKED DEPRESSED AND UNWELL WHEN I SAW HIM ON 26 JANUARY.

WRIGHT

YYYY

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TRIPOLI

Repetition to .....
referred for departmental decision.
reported as requested to other posts

Prime Minister 2

CONFIDENTIAL

MR NORGROVE

24 January 1986

THE OIL MARKET

Now that the anticipated slide of oil prices has occurred, there is a widespread tendency to see them descending to some floor level at which equilibrium will be re-established. On that presumption, Yamani's talk of oil prices falling below $15 per barrel sounds alarming. Perhaps fortunately, things are not that simple. Until OPEC contrive a credible new form of self-discipline and reassert a grip on the oil market, I foresee a period in which oil prices will be unusually volatile - varying perhaps in the range $15-25 per barrel.

The first point to bear in mind is that oil producers only produce on demand, ie when there are buyers ready to lift the oil. Although there may be short-term deviations between world oil production and consumption, the system is self-correcting, albeit not as smoothly as when the Saudis fulfilled the balancing rôle in support of high oil prices.

During the recent mid-Winter period, world oil production has exceeded the underlying level of consumption by roughly 2 million b/d. Now that prices are tumbling, buyers on the margin will be hanging back expecting lower prices in the future. With fewer buyers in the market, marginal production must perforce be shut back. Today's rate of production may already be below the rate of consumption. Unfortunately, that is unlikely to be of much help in the immediate future because

so much oil is already on the water, destined for the major markets of Europe, North America and the Far East. For the next month or two, this is likely to exert a continuing downward pressure on oil prices.

However, another important consideration is the extremely low level of oil stocks throughout the oil industry - for good commercial reasons. This means that there is nothing to cushion the impact of sudden panics in the market. Any one of a number of factors - a snap of cold weather, a flare-up of the Iran/Iraq War, or the sudden switching of heavy industry and power stations from coal or gas to cheap fuel oil - could bring the buyers rushing into the market and lead to a sharp upturn of oil prices, only to be followed by a subsequent fall.

Meanwhile, what, if anything, can we do to encourage OPEC members to reassert a grip on the oil market in support of stable highish prices? The siren voices urging co-operation from non-OPEC producers are already being heard as close to home as Norway. Our policy line is to sit poker-faced and assert that OPEC oil members alone have both the self-interest and the means to manage the oil market in support of higher prices. After all, OPEC accounts for 14 million b/d of the 20 million b/d of oil which is traded internationally. Certainly, it would seem counter-productive to let producers like Nigeria, Iran and Iraq believe that relief is nigh in the form of non-OPEC co-operation.

The one snag in this policy line is that Saudi Arabia has got out on a limb over its declared insistence on a gesture of support from the UK. No OPEC initiative could succeed without Saudi Arabia, so there may come a time when it serves our interest to cast around for a face-saving symbolic gesture to the Saudis; but certainly not until Saudi Arabia's OPEC partners have become painfully aware of the paramount need for credible, sustainable self-discipline on their part. At that point, it might, for example, be worth expressing the belief that the rate of UK oil production in 1986 and 1987 will not exceed that in 1985; on current plans and forecasts, this will happen in any case.

Risk of slippery slopes here.

JOHN WYBREW

NI7237 5 XXX 128

OIL WORRIES BATTER STERLING

OIL PRICE WORRIES HAVE ONCE AGAIN PUT THE SKIDS UNDER STERLING TODAY.

THE POUND SLUMPED TO 1.3905 DOLLARS, DOWN 60 POINTS, AFTER FALLING BELOW 1.39 AT ONE STAGE ON REMARKS BY SAUDI OIL MINISTER SHEIKH YAMANI THAT A PRICE OF LESS THAN 15 DOLLARS A BARREL IS PROBABLY UNLESS OPEC AND NON-OPEC PRODUCERS CO OPERATE TO BRING SOME ORDER BACK INTO THE MARKET.

THE POUND SLIPPED TO 3.4060 GERMAN MARKS (3.4111), WITH THE TRADE WEIGHTED INDEX AT 75.1 (75.3).

MEANWHILE, THE PRICE OF MARSH BRENT OIL TRADED AS LOW A 18.60 DOLLARS A BARREL ON THE ROTTERDAM SPOT MARKET.

DEALERS SAID THE ONLY THING HOLDING STERLING UP WAS THE APPARENT INEVITABILITY OF AN INCREASE IN UK BANK BASE RATES, TODAY OR TOMORROW.

--

PRESS ASSOCIATION NEWS AT 1PM

... OIL PRICE COULD FALL TO 15 DOLLARS A BARREL UNLESS OPEC AND NON-OPEC NATIONS CO-OPERATE, SAYS SAUDI OIL MINISTER SHEIKH YAMANI. POUND DIPPED TO 1.3905 DOLLARS AFTER THE WARNING.

RR7.79

Prime Minister 2
DRS
27/1

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

22 January 1986

The Rt. Hon. Peter Walker MBE MP
Secretary of State for Energy

MS

Dear Secretary of State

OIL PRICES

Thank you for your letter of 22 January. WITHDRAWN

I share your general assessment of the position in the oil market. Despite the inevitable difficulties caused by the sharp fall in the oil price, I entirely agree that we should stick to our longstanding policy of non-intervention in UKCS production levels. As you say, any change in policy could create misunderstandings both with OPEC and with OECD countries. On top of that, any cutback in UKCS production is likely to be very costly indeed to the Exchequer. It is also likely to damage the confidence of oil companies in the UKCS and so reduce future exploration and development activity. The plain fact is that we are in a far stronger position to take a sharply lower oil price in our stride than most other oil-exporting nations.

In view of this I trust that, in any contacts with oil producers, our determination to stand by our present policy will be made clear.

I am copying to the Prime Minister, Geoffrey Howe, Leon Brittan and Sir Robert Armstrong.

Yours sincerely

pp NIGEL LAWSON
(approved by the Chancellor and signed in his absence)

ENERGY PT2

Oil Prices

SECRET

Copy No 1 of 4

PRIME MINISTER

OIL PRICES

You will have seen my letter of 22 January to Nigel Lawson about developments in the oil market.

Shaikh Yamani telephoned me today from Geneva to follow up the conversation Geoffrey Howe had with Prince Saud. He said that he had intended to be in London this week, and would have wished to see me, on a private basis, to discuss the state of the oil market. However he had influenza and would be unable to visit London before becoming tied up by his son's forthcoming wedding.

I said that it would be impossible for me to come to Geneva on Thursday because of Cabinet and the Gas Bill. He very readily agreed to leave matters for the present, and suggested we speak on the phone again with a view to arranging a meeting at the end of February.

The conversation then turned to the likely future trend in the oil price. I was non-committal. Yamani said that he thought prices would continue to fall until they bottomed out at $15 per barrel. When I pressed him for the reasoning behind this figure he was unspecific about the mechanism, merely suggesting that the degree of chaos this would cause in the financial markets and in the oil companies would be so intolerable as to necessitate a halt.

It is impossible to be certain, but my guess is that Yamani was sounding out our willingness to take some (unspecified) action. If I had seemed keen to have a meeting, he would have pressed for it to be early rather than later.

I still do not believe there is anything we can or should do on production or otherwise which would have the desired effect. We clearly need to consider carefully the line I should take at any meeting in

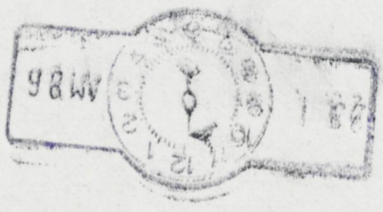
SECRET

February. But we now have a breathing space which will allow us to see more clearly how the market is developing, and for officials to prepare an assessment of the implications.

I am copying this minute to Geoffrey Howe and Nigel Lawson.

Secretary of State for Energy
22 January 1986

Energy: Oil Prices.



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Prime Minister 2

DRS
22/1

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

01 211 6402

The Rt Hon Nigel Lawson MP Esq
Chancellor of the Exchequer
H M Treasury
Parliament Street
London
SW1

22 January 1986

OIL PRICES

You will no doubt have seen that the price of North Sea oil for delivery in April has gone below $20 and was some $19.40 at 4 pm on 21 January. I felt I should draw this to the attention of colleagues, since $20 has become for many a psychological barrier.

As I said in my minute to the Prime Minister of 11 December, there is a surplus of production over demand, which could reach some 2 to 4 million barrels a day by the second quarter of this year. The price of North Sea oil for prompt delivery has fallen from almost $31 ~~(million)~~ at the end of last November, through $26 in the Christmas period, to $20.50 now.

It is, of course, impossible to forecast how oil prices will move in the period ahead. Dr Hammer recently expressed a generally optimistic view to the Prime Minister. On the other hand, Peter Holmes of Shell has recently said that his private view is that oil prices could well fall to $15 before the middle of the year. With the removal of OPEC support, there is no obvious higher level at which the slide might be expected to stop.

The OPEC Committee on market share, set up at the last OPEC Conference, is due to meet in the first week of February. It is unlikely to agree any effective action, and may only pave the way for an emergency full Conference. Meanwhile, the Saudis are sticking to their aim of increasing production and are reliably reported to be producing nearly 5 million barrels a day, some 650,000 bpd above their quota and 3 mbpd above their production level last summer. Financially they are clearly better off at this level of production at current prices than they were in the summer, when they were only producing some 2 mbpd at a price of about $25 a barrel. It therefore seems likely that the market will become even

SECRET

more nervous towards the end of this month, and that the Saudis have persuaded themselves that a further slide in the oil price is the only effective way of putting pressure on OPEC and non-OPEC producers alike.

As you know, demand reacts fairly slowly to lower prices and so it is probable that only renewed restrain by OPEC will really stabilise the oil price in the short term. It is hard to see whether and when such restraint will occur; but a lower oil price will put considerable pressure on oil dependent economies, particularly OPEC members and those with little room to increase production.

In short, I do not think we should be too optimistic about the prospect for oil prices, and you will obviously be considering the implications for both the domestic and international economies.

I should add that we continue to receive a series of unsolicited proposals, which would involve us in a greater or lesser degree of intervention. At one extreme, Dr Al Chalabi, the acting Secretary-General of OPEC argued at a recent Ditchley Conference for full-blooded co-operation between OPEC and non-OPEC producers, while Peter Holmes has himself on occasion argued that it was in HMG's enlightened self-interest to adopt royalty banking, at least in the summer. The theme of all these suggestions has been that we should try to help OPEC save face by some gesture, after which the Saudis would be prepared to re-establish OPEC discipline. Since the New Year we have received more specific suggestions; for instance, our Ambassador in Abu Dhabi has reported that Dr Otaiba has suggested that we should say that UKCS production would not exceed its current level (but production is likely to be 2% higher in 1986); while Dr Parra, the London representative of the Venezuelan State Oil Company, has suggested that we should be prepared to state publicly that the production will fall in the summer (which regularly happens in any case as a result of maintenance work). Any such steps would be inconsistent with our market stance on oil prices and could in any case give rise to misunderstandings both with OPEC and our OECD partners.

I am copying this letter to the Prime Minister, Geoffrey Howe, Leon Brittan and Sir Robert Armstrong.

PETER WALKER

~~E~~

ENERGY P12

Ou Phcs

21.1.

ADVANCE COPIES 28

OIL

PS
PS/MR EGGAR
PS/PUS
MR BRAITHWAITE
MR GOODALL
MR O'NEILL
MR DAVID THOMAS
MR EGERTON

HD/ESSD
HD/WAD
HD/ERD
HD/ECONOMIC ADVISERS
HD/MCAD
HD/MED
HD/SEAD
HD/NENAD

RESIDENT CLERK

PS/NO 10 DOWNING STREET
MR C E HENDERSON, (Hd. OIL Div.Room 1445 } DEPT OF ENERGY
MR ARNOTT
MR RICKETT
MR FREMANTEL } THAMES HOUSE SOUTH
PS/ S of S FOR ENERGY

MISS P LEAHY HM TREASURY

MR R MARTIN, Rm 116
MISS LACKEY WEG } DTI (Victoria St)
MR D FORD CT5

17.12.85

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FM RIYADH
TO IMMEDIATE FCO
TELNO 038
OF 150200Z JANUARY 86
INFO PRIORITY UKREP BRUSSELS, WASHINGTON, UKDEL OECD

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IMMEDIATE

MY TELNO 34 (NOT TO ALL)

FROM PRIVATE SECRETARY

SECRETARY OF STATE'S TALKS WITH PRINCE SAUD : OIL MATTERS

1. AS EXPECTED PRINCE SAUD EXPRESSED CONCERN TO THE SECRETARY OF STATE TODAY ABOUT THE PROSPECTS FOR THE OIL MARKET. THERE WAS A CLEAR POSSIBILITY OF A SHARP DECLINE IN PRICE WHICH WOULD BE DAMAGING TO THE WORLD ECONOMY AND PARTICULARLY TO MARGINAL PRODUCERS. OPEC ALONE COULD NOT PREVENT THIS. THE SAUDIS WOULD LIKE TO OPEN A CHANNEL FOR CONSULTATIONS WITH BRITAIN WHOSE ROLE COULD BE A KEY ONE.

2. THE SECRETARY OF STATE REPLIED THAT WE SHARED SOME OF THE SAUDIS ANXIETIES. THE ENTIRELY FREE PLAY OF MARKET FORCES COULD CREATE DIFFICULTIES BUT SO COULD ANY ATTEMPT TO WORK AGAINST THEM. SINCE BOTH COUNTRIES WERE PRODUCERS AS WELL AS CONSUMERS, THERE WAS VALUE IN AN EXCHANGE OF VIEWS WITHOUT NECESSARILY REACHING CONCLUSIONS. OIL PRODUCTION IN BRITAIN WAS A MATTER FOR THE COMPANIES AND THE MARKET PLACE. IT WOULD BE VERY DIFFICULT TO INFLUENCE PRODUCTION LEVELS WITHOUT AFFECTING FUTURE INVESTMENT.

3. PRINCE SAUD REPEATED THAT HE WISHED TO TAKE THE OPPORTUNITY OF THIS VISIT TO ESTABLISH A LINE OF COMMUNICATION WHICH WOULD BE IN OUR MUTUAL INTEREST. HE HOPED HE COULD ADVISE SHAIKH YAMANI TO BE IN TOUCH WITH THE DEPARTMENT OF ENERGY. THE SECRETARY OF STATE REPLIED THAT HE KNEW THAT THE SECRETARY OF STATE FOR ENERGY ATTACHED IMPORTANCE TO HIS CONTACTS WITH YAMANI AND WAS SURE THAT THEY WOULD CONTINUE TO BE HANDLED DISCREETLY.

WRIGHT

Prime Minister 2

John Wybrew's earlier bearishness about the oil price has been proved right.

CONFIDENTIAL

MR NORGROVE

10 January 1986

THE OIL MARKET

The game of poker being played out by the world's oil producers shows little sign of reaching a quick and painless end.

Saudi Arabia is still producing more than 4 million b/d - close to its nominal share of the OPEC ceiling of 16 million b/d. Moreover, the Saudis have concluded contractual arrangements with the major oil companies to secure firm outlets for this level of production, irrespective of how the oil price moves. Other OPEC members, especially those able to entice the oil companies with long-term relationships, are busily making similar arrangements.

The world's producers are estimated currently to be producing 1½-2 million b/d in excess of world demand. Oil stocks have begun to rise. The northern winter has not been severe. Sellers of oil without secure outlets are beginning to have difficulty in finding buyers.

The scene is set for a rapid slide of oil prices. The market is edgy. Any time bearish sentiment could build up. Buyers will hold back anticipating lower prices. Those sellers without firm outlets - not least in the North Sea - will be forced to cut prices and scramble for what little

business there is. Mexico and its bankers are potentially exposed when such a scramble develops.

My guess is that oil prices will quickly fall below $20 per barrel. Alarmed OPEC members will sink their differences, curb production and reassert a grip on the market. When prices fall below $20 per barrel, OPEC should be helped by the switching of electricity utilities and some heavy industry from coal and gas into fuel oil. We must fasten our seatbelts and let this process work itself out. Any hint of intervention by HMG will be counter-productive.

JOHN WYBREW

file

CCBG

10 DOWNING STREET

From the Private Secretary

16 December 1985

OIL PRICES

The Prime Minister was grateful for your Secretary of State's minute of 12 December.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and Rachel Lomax (H M Treasury).

DAVID NORGROVE

Geoff Dart, Esq.,
Department of Energy

SECRET

cc BG Gretton.

Copy No 1 of 5

PRIME MINISTER

OIL PRICES

At the end of November, the price of North Sea crude stood at slightly over $30 a barrel. By this morning the price had fallen to below $22. It climbed back to $25½ at 4.00 pm this afternoon, but the market is still very volatile and it would be rash to assume prices have stabilised. I believe I should spell out the background to this slide in oil prices and warn you that we will face growing pressure to cut UK production from OPEC and from Saudi Arabia in particular.

Until this summer, OPEC had made no serious attempt to break free from its position as residual supplier. In particular, Saudi Arabia reluctantly acquiesced in its effective role as swing producer. Despite having the capacity to produce some 10 million barrels/day, Saudi production fell from that level in 1979 to just over 2 mb/d this summer. Over the same period, OPEC production fell from 31½ mb/d to some 14 mb/d. In this way, declining world demand and a rise in non-OPEC production from 20 mb/d in 1979 to 25 mb/d in 1985 were largely accommodated without a serious collapse in oil prices, although prices did fall steadily from a peak of around $40 in 1981 to a low of $25 in June of this year.

Over the last 6 months, it has become increasingly clear that Saudi Arabia will no longer accept its position as swing producer. As such, it has had to cut production at times of falling prices and in a steadily falling market it is no longer willing to accept

SECRET

the consequent decline in oil revenues. This change of attitude may well have been sparked by the events of this summer, when Saudi production and oil prices both reached a low point simultaneously. Even in the spring, they were heading for a trade deficit of some $20 bn.

From late September, Saudi Arabia began to conclude a number of "netback" deals. Under these deals, Saudi oil is sold at a price related to the price the refiner obtains for oil products. The customer is therefore guaranteed a margin on such oil. In this way Saudi Arabia not only secured an outlet for increased production but also gave up its attempt to support prices. Sheikh Yamani has confirmed publicly that Saudi Arabia can no longer support prices, and has threatened that Saudi production will be allowed to rise to maintain revenues as prices fall. It is now producing close to its quota of 4.39 mb/d.

This, together with similar deals by other major OPEC producers, means that OPEC production as a whole is now some 18 million barrels/day. Attached is a table giving the latest projection of the balance of supply and demand produced by my Department. It shows that if OPEC continues to produce at the current 18 mb/d there is likely to be a surplus in the market of some 2 mb/d in Q1 of 1986 rising to 3 mb/d in Q2 and Q3. This compares with current UK production of some 2.7 mb/d. It is the perception that OPEC will take no action to restrain production that has driven prices down so fast.

The OPEC conference this weekend has been portrayed as having agreed

a strategy of defending market share regardless of the effect on price. However, I do not think it is as simple as this. There are still deep divisions within OPEC. Libya, Algeria and Iran, for instance, still believe in the aim of stabilising prices at current levels or higher. Most OPEC members will be worse off because of the fall in prices. Saudi Arabia might benefit if it can obtain a larger market share or if demand increases but the latter is a long term prospect. However, one can say that all OPEC members are agreed that non-OPEC producers should share the burden, and that many members found the presentation of a confrontation with non-OPEC producers an attractive means of disguising their differences. Some may believe that a fall in prices to below $20 will shock us into action, and that probably lies behind the threats of a price war made publicly by the Saudis, Kuwait and Nigeria.

We can therefore expect renewed pressure from OPEC, public and private, to cut our production. I have had reports that Yamani is speaking of maintaining a "fair share" of the market irrespective of price, and that he considers that a "fair share" can only be defined in negotiations with non-OPEC producers.

I believe we should continue to resist this pressure. Apart from the general principle of not interfering in the market:

(a) OPEC show no evidence at present of sufficient unanimity to make any "deal" with them workable, even if that were desirable; and unilaterial gestures on our part would be expensive and would achieve nothing if OPEC

did not respond quickly and constructively, which I consider most unlikely;

(b) the breach of trust with our licensees could damage the prospects of investment in the UKCS, even though some oil companies may see commercial advantage in higher prices brought about by Government action;

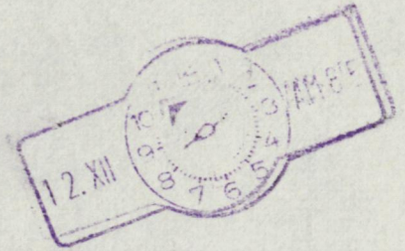
(c) my Department is predicting that the decline in oil demand is unlikely to reverse significantly before 1990: we would therefore run the risk of locking ourselves into lower production for some years and of sharing with Saudi Arabia the burdens of residual supplier; and

(d) in taking specific action to support prices, we could well damage relations with our EC and OECD partners, including the USA, who in general are likely to favour lower oil prcies. As the largest oil consumer, the USA could arguably do more to influence prices than us, if it felt its interests were being threatened.

I am copying this to the Foreign and Commonwealth Secretary and to the Chancellor of the Exchequer.

Secretary of State for Energy

12 December 1985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TELNO 53
OF 270720Z JAN 86
AND INFO DESKBY 270900Z DEPARTMENT OF ENERGY
INFO PRIORITY ABU DHABI,BAHRAIN,DUBAI,DOHA,RIYADH,KUWAIT

OMAN : OIL PRICE

SUMMARY

1. THE RECENT FALL IN THE OIL PRICE CAUSES OMAN SERIOUS PROBLEMS. DEVALUATION OF THE RIAL ONLY A PARTIAL SOLUTION : CUTS IN GOVERNMENT EXPENDITURE WILL ALSO BE NECESSARY. THE MINISTER FOR PETROLEUM HAS BEEN INSTRUCTED BY THE SULTAN TO GO TO LONDON FOR EMERGENCY TALKS WITH THE BRITISH GOVERNMENT. I HAVE TOLD HIM THAT THERE IS NO PROSPECT OF A CHANGE IN HMG'S POLICIES. BUT I HOPE THAT HE MAY BE GIVEN A SYMPATHETIC HEARING.

DETAIL

2. AS EXPLAINED IN MY TELEPHONE CALL OVER THE WEEKEND TO SIR D MIERS,THE OMAN MINISTER FOR PETROLEUM,SAID BIN AHMAD AL SHANFARI,HAS BEEN INSTRUCTED BY THE SULTAN TO GO TO LONDON TO TALK TO THE BRITISH GOVERNMENT ABOUT MEASURES TO STABILISE THE OIL PRICE. I UNDERSTAND THAT MR WALKER HAS KINDLY AGREED TO RECEIVE HIM EARLY THIS WEEK. SHANFARI IS ANXIOUS THAT HIS VISIT SHOULD BE KEPT COMPLETELY CONFIDENTIAL.

3. THE RECENT FALL IN THE OIL PRICE HAS CONFRONTED THE GOVERNMENT OF OMAN WITH A DIFFICULT SITUATION. THE THIRD FIVE YEAR PLAN,WHICH WAS PUBLISHED ONLY THREE WEEKS AGO,WAS BASED ON AN OIL PRICE OF BETWEEN 22 DOLLARS AND 23 DOLLARS PER BARREL : ALL THIS HAS NOW BEEN THROWN INTO DISARRAY. THE GOVERNMENT YESTERDAY DEVALUED THE OMANI RIAL FROM 2.86 DOLLARS TO 2.60 DOLLARS (A REDUCTION OF SOME 11%). IN PARALLEL,AND TO SOFTEN THE IMPACT OF INCREASED IMPORT PRICES ON THE PRIVATE SECTOR,THE MAXIMUM RATE OF INTEREST TO BE CHARGED FOR OVERDRAFTS HAS BEEN BROUGHT DOWN ONE PERCENTAGE POINT TO 10 1/2 %.

14

CONFIDENTIAL

4. THE EFFECT OF THE DEVALUATION WILL BE TO INCREASE THE RIAL VALUE OF OMAN'S OIL EXPORTS AND TO IMPROVE THE BALANCE OF PAYMENTS BY DISCOURAGING IMPORTS AND OVERSEAS REMITTANCES. IT WILL ALSO HAVE THE EFFECT OF PUTTING UP THE COST OF LIVING. BUT EVEN AFTER THE DEVALUATION, THE BOOKS DO NOT BALANCE. WE ESTIMATE THAT IF THE AVERAGE PRICE OF OIL IN 1986 IS 18 DOLLARS PER BARREL AND IF OMAN INCREASES HER OIL PRODUCTION TO AN AVERAGE 575,000 BARRELS PER DAY, THERE WILL BE A BUDGETARY DEFICIT OVER THE YEAR OF SOME OMANI RIALS 100M. TO ADD TO THE ALREADY PLANNED DEFICIT OF OR 175M. THIS COULD BE MET BY DRAWING ON RESERVES : BUT OBVIOUSLY THIS PROCESS CANNOT CONTINUE FOR LONG. THE BUDGETS OF ALL THE MINISTRIES ARE CURRENTLY UNDER EMERGENCY REVIEW AND ECONOMIES ARE BEING SOUGHT. IF THE OIL PRICE FALLS BELOW 18 DOLLARS, FURTHER MAJOR CUTS WILL BE NECESSARY. SOME PLANNED PROJECTS WOULD HAVE TO BE POSTPONED. THE CANCELLATION OF SOME CONTRACTS, INCLUDING DEFENCE CONTRACTS, CANNOT BE RULED OUT. THE CRISIS IS THUS LIKELY TO HAVE ADVERSE EFFECTS ON BRITISH EXPORTS TO OMAN.

5. LIKE OTHERS, OMAN WOULD LIKE TO SEE OPEC RESTORE PRODUCTION DISCIPLINE. IN AN INTERVIEW ACCOMPANYING THE ANNOUNCEMENT OF THE DEVALUATION, THE UNDER-SECRETARY AT THE MINISTRY OF PETROLEUM AND MINERALS ATTRIBUTED THE FALL IN PRICES TO OVER - PRODUCTION BY COUNTRIES WHICH HAVE QUOTAS. THE ANNOUNCEMENTITSELF PREDICTED FURTHER FALLS IN PRICE UNLESS THERE WERE BETTER COORDINATION OF PRODUCTION POLICIES, PARTICULARLY WITHIN OPEC.

6. THE OMANIS HAVE SHOWN NO DISPOSITION TO CRITICISE THE UK (THEY SCARCELY COULD SINCE, AS NON-MEMBERS OF OPEC, THEY HAVE THEMSELVES BEEN MAXIMISING PRODUCTION). BUT IN PRIVATE BOTH THE MINISTER FOR PETROLEUM AND THE UNDER-SECRETARY FOR FINANCE HAVE MADE CLEAR TO US THEIR HOPE THAT BRITAIN WILL COME TO AN ARRANGEMENT WITH OPEC TO TAKE SURPLUS PRODUCTION OUT OF THE MARKET.

7. THE MINISTER'S VISIT TO LONDON IS A FURTHER EXAMPLE OF THE OMANI GOVERNMENT'S INSTINCT TO TURN TO BRITAIN IN TIMES OF DIFFICULTY. I HAVE MADE CLEAR TO THE MINISTER THAT THE BRITISH GOVERNMENT'S POLICY REMAINS THAT PRICES AND PRODUCTION ARE A MATTER FOR THE MARKET AND THAT THERE IS NO PROSPECT THAT HMG WILL INTERVENE TO RESTRICT NORTH SEA PRODUCTION. I, NEVERTHELESS, HOPE THAT WHEN HE SEES MR WALKER HE WILL BE GIVEN A SYMPATHETIC HEARING.

SLATER

STANDARD (~~PALACE~~)

ESSD
ERD
TRED
ECONOMIC ADVISERS
ECD'S
MED
NENAD
SAMD
MCAD
WAD
SEAD
WED
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MR JOHNSON
SIR D MIERS

ADDITIONAL DISTRIBUTION

OIL

CONFIDENTIAL

MR NORGROVE 10 December 1985

THE OIL MARKET

Two months ago, Saudi Arabia abandoned its role as OPEC's swing producer, changed its pricing policy and boosted production from 2 to 4 million b/d - close to is nominal share of OPEC's official production ceiling of 16 million b/d.

Against that background, it was inevitable that the outcome of last weekend's OPEC meeting would be confused, with conflicting signals from the principal factions. One group (including Algeria, Iran, Libya and Venezuela) shudders at the prospect of taking on non-OPEC producers in an oil price war, sees little prospect of inducing non-OPEC producers to collaborate in defending high oil prices, and wants OPEC members to go on exercising production restraint. The other wing, now with the notable inclusion of Saudi Arabia, wants to raise the stakes and play a more risky hand, albeit with the same objective of maintaining stable, high oil prices.

The key figure in this war of nerves is Saudi Arabia which, significantly, has distanced itself from the new OPEC committee charged with finding a solution. The latest reading from well-informed oil industry sources, suggests that the Saudis are now persuaded that OPEC alone can no longer cope on a lasting basis. Oil demand is too slack and non-OPEC production too buoyant. Yamani has a new remit from the Royal Family; Saudi Arabia will not throttle back its 4 million b/d

production until the oil price is low enough to induce the non-OPEC producers, notably the UK, to collaborate with OPEC in defending stable, high oil prices.

If the Saudis really are bent on this course, there are no short-term physical or economic factors which would stop them driving oil prices below $20 per barrel. Consumers have adjusted to high oil prices and demand is largely inelastic until - somewhere below a price of $20 per barrel - power stations and heavy industrial consumers consider switching their dual-fired boilers to fuel oil. With the possible exception of some marginal US production (perhaps defended by a US oil import levy), most non-OPEC fields will continue to produce at maximum rate because the marginal operating costs are well below $10 per barrel.

If high-cost UK production really is the primary target of Saudi Arabia and some of its OPEC supporters, should we be contemplating any form of response? Emphatically no. Saudi Arabia is the one producer which has the short-term potential to increase production sufficiently to offset falling oil prices. For the rest of OPEC, the trade-offs between price and volume in an inelastic market make it compellingly obvious that their collective self-interest lies in foregoing marginal production to defend high prices. This may still be unthinkable - from the point of view of face and honour - without support from the non-OPEC producers. It won't be in a month or two, when oil prices are tumbling. Before then, any concession by the UK Government would be irreversible - and

thereafter regretted. (This week's sharp falls in the spot price of oil are probably a short-term psychological reaction to the OPEC meeting. The physical basis for a prolonged slide is still a month or two away.)

Conclusion

Peter Walker should do nothing. That is likely to mean a bumpy ride for Nigel Lawson. It is none too soon to consider the implications.

JOHN WYBREW

ADVANCE COPIES 35

OIL

PS
PS/MR EGGAR
PS/PUS
MR BRAITHWAITE
MR GOODALL
MR O'NEILL
~~MR J THOMAS~~
MR DC THOMAS
MR EGERTON

HD/EnSSD
HD/WAD
HD/ERD
HD/ECONOMIC ADVISERS
HD/MCAD
HD/MED
HD/SEAD
HD/NENAD

RESIDENT CLERK

PS/NO 10 DOWNING STREET

MR CE HENDERSON, HD/OIL DIV, ROOM 1445
MR HIGSON
MR FREEMANTEL
MR W. RICKETT
PS/ S of S FOR ENERGY
} DEPT OF ENERGY
} THAMES HOUSE SOUTH

MR RG LAVELLE
MR P LEAHY
MR S ROBSON
} HM TREASURY

MR R MARTIN, Rm 116
MISS LACKEY (WEG)
MR D FORD (CT5)
} DTI (Victoria St)

~~MR GRAHAM HARRISON~~ ~~ODA~~

[Dept of Energy
Treasury : telephoned but no reply received
advised by Home Service Messages]

RESTRICTED
FM UKMIS GENEVA
TO IMMEDIATE DESKBY 091730Z FCO
TELNO 453
OF 091605Z DECEMBER 1985
INFO IMMEDIATE DESKBY 091730Z DEPT OF ENERGY
INFO IMMEDIATE DESKBY 091730Z TREASURY
INFO PRIORITY JEDDA, JAKARTA, LAGOS, KUWAIT, DOHA, ABU DHABI,
INFO PRIORITY MUSCAT, BIS TEHRAN, CARACAS, BAGHDAD, ALGIERS, QUITO,
INFO PRIORITY MEXICO CITY, BAHRAIN, DUBAI, RIYADH.
INFO ROUTINE OSLO, CAIRO, KUALA LUMPUR, BANDAR SERI BEGAWAN, OTTAWA,
INFO ROUTINE LIBREVILLE, WASHINGTON, UKDEL OECD PARIS, VIENNA.

OPEC MINISTERIAL MEETING (7-9 DECEMBER)

1. MEETING ENDED AT 1415 LOCAL TIME TODAY (9 DECEMBER). MALAYSIA AND MEXICO WERE PRESENT AS OBSERVERS. DURING MORNING IRAN, ALGERIA AND LIBYA ALL BACKED OUT OF NEWLY-FORMED RESEARCH COMMITTEE, APPARENTLY WORRIED ABOUT CONSEQUENCES ON PRICES OF INCREASING PRODUCTION LEVELS.

2. IN A FINAL COMMUNIQUE, GRISANTI (VENEZUELA AND NEW OPEC PRESIDENT) TOLD JOURNALISTS THAT HAVING CONSIDERED PAST AND LIKELY FUTURE TRENDS IN THE MARKET, AND IN VIEW OF THE DECLINING TREND OF OPEC PRODUCTION, OPEC HAD FORMED A SPECIAL COMMITTEE, HEADED BY HIMSELF, QUOTE TO SECURE AND DEFEND A FAIR SHARE OF THE MARKET FOR OPEC PRODUCERS, CONSISTENT WITH THE NECESSARY INCOME FOR THE DEVELOPMENT OF ITS MEMBER COUNTRIES UNQUOTE. OTHER COMMITTEE MEMBERS WOULD BE AL-ORAIBI (IRAQ), AL-SABAH (KUWAIT), SUBROTO (INDONESIA) AND OTAIBA (UAE). THE COMMITTEE WOULD BEGIN ITS WORK IMMEDIATELY, AND REPORT TO THE NEXT MINISTERIAL MEETING ON 25 JUNE 1986. THE COMMITTEE WOULD BE ASSISTED IN ITS WORK BY EXPERTS FROM ALL OPEC COUNTRIES.

COUNTRIES.

3. ANSWERING QUESTIONS, GRISANTI SAID THAT OPEC HAD NOT PUT A FIGURE ON WHAT IT CONSIDERED TO BE ITS FAIR SHARE OF THE MARKET. ASKED ABOUT SHORT-TERM PRODUCTION OR PRICING PLANS, GRISANTI STATED THAT ALL PREVIOUS OPEC RESOLUTIONS WERE STILL REGARDED AS BINDING. ON THE QUESTION OF STARTING A PRICE WAR, GRISANTI SAID THAT THIS WAS NOT OPEC'S INTENTION, BUT THAT THE COMMITTEE WOULD CONSIDER WHAT INSTRUMENTS MIGHT BE USED TO PROTECT THE INCOME OF OPEC MEMBER STATES. HE POINTED OUT THAT ALTHOUGH OPEC'S SHARE OF WORLD OUTPUT HAD DECLINED, OVER 60% OF THE OIL TRADED ON INTERNATIONAL MARKETS STILL CAME FROM OPEC COUNTRIES.

MOSS

Prime Minister 2
To note
DRN
11/11

PM threw out of
Glat 23/12/85

CONFIDENTIAL

MR NORGROVE

8 November 1985

THE OIL MARKET

There is a striking contrast between the current buoyant state of the oil market and the gloomy prognosis for next Spring. Today, North Sea oil is nudging $30 per barrel, yet some bets would have it below $20 per barrel by the Spring. It may be helpful to separate the facts from speculation about how the poker game between the producers is played out.

The Facts

World oil demand is stagnant, and likely to remain so next year. Oil stocks continue at minimum operational levels, because no-one wants to hold a commodity in an over-supplied, falling market. Saudi Arabia has abandoned its role as OPEC's swing producer, changed its pricing policy and has boosted production from 2 to 4 million barrels per day - close to its nominal share of OPEC's official production ceiling of 16 million barrels per day.

The timing of Saudi Arabia's move was shrewd. The additional oil will hit the market just as the hand-to-mouth demand from oil buyers approaches its Winter peak. Meanwhile, buyers who have held back until the last moment are scrambling to meet early Winter demand. Heating oil stocks are particularly low in North America. Hence, the recent hardening of spot oil prices.

Forecasts of how long the market will remain firm range from December to next March, partly depending on the severity of the Winter. Thereafter, something will have to give. Assuming no growth of OPEC's production between 1985 and 1986, there is still likely to be a production surplus exceeding 1 million barrels per day.

The Speculation

Some OPEC producers, such as Iraq, Nigeria and Ecuador, are apparently intent on raising production. Even if Saudi Arabia is prepared to throttle back after this Winter, supply and demand cannot be balanced. Before long, oil prices will start falling rapidly. When the OPEC producers meet, it will take more than good intentions to arrest the slide; the price floor created by normal physical and economic factors is much lower than anyone dare contemplate. The poker game will be at its most intense. Non-OPEC producers will be urged to join in.

However, the players recognise that this is a game which none of them can win. Their oft-displayed survival instincts may yet result in the players throwing in their hands and finding a compromise solution. That would still be my bet.

JOHN WYBREW

PRIME MINISTER

CONTRIBUTION OF OIL TO GDP GROWTH

The Labour recovery ran from the second half of 1975 to the first half of 1979. During that period oil contributed around one percentage point of annual GDP growth. In the current recovery, the first half of 1981 to the six months to March 1985, oil has accounted for annual growth of only half a percentage point.

DAVID NORGROVE

30 October 1985

LOSANL

SECRET

Reference Copy no 32 of 13.

CC NO

24

I agree. DWB 2/10

To:
1. Mr Bowder
2. PS/Mr Pattie

3. PS/Secretary of State

cc PS/M F T 1
PS/PM 2
Mr Macdonald 3
Mr Roberts 4
Mr Liesner 5
Mr Titchener OT4 6
Mr Michell Air 7
Mr Wright GP 8
Mr Thornton GP 9
Mr Gill ECGD 10
Mr Benjamin PEP 11

From:

MISS M F DAVIS
Air 2
VA 6/1
2 October 1985

Mr Walker has written to the Prime Minister on 25 September to express his concern because he was not consulted about the implications for the oil market of the Saudi purchase of British Aerospace aircraft.

Mr Heseltine's minute of 26 September to the Prime Minister recalls that because of Saudi sensitivities, the Prime Minister directed that the negotiations should be kept to a very limited circle. He recognises that this has made for less than ideal handling within Government, but the Saudi interest in payment by oil only emerged late in the day. Mr Heseltine accepts that it would have been better if Department of Energy officials had been brought in as the final package had emerged but this had now been rectified.

Similarly, officials in this Department were not consulted on the details of the deal. Our information was limited to knowing that negotiations for sales of Tornado were in progress and, like Mr Walker, we heard of the full extent of the deal from the Press. But in view of the sensitivity of the deal, this is not surprising. Payment in oil is not new. Last year the Saudi Government made payments in oil for Rolls Royce B747 engines. At that time, Department of Energy asked for prior information of any potential deals of which Departments became aware. But as Mr Heseltine has explained, there may be particular circumstances which mean that Departments may only be involved at a late stage in a deal.

We understand from the Ministry of Defence that the agreement is that the deal for 48 Tornado IDS aircraft, 24 Tornado ADV aircraft, 30 Hawks and 30 PC-9 Turboprop trainers (produced by Pilatus of Switzerland in association with BAe) should be entirely financed by oil, up to an amount $4 billion. British Aerospace would have to play a role with BP as an agent having an interest in the deal. BAe have already been involved by the Ministry of Defence in these discussions. BAe are of course delighted with the contract which is their biggest single order ever and should help to maintain production levels at Warton until the European Fighter Aircraft comes into production.

CODE 18-77

On the question of offset which was also raised by the Saudis at a late stage, there is nothing fixed as yet but Mr Heseltine has promised to do what he can. He has written to the Prince Sultan that HMG "will arrange for a delegation consisting of representatives of appropriate British companies to visit the kingdom of Saudi Arabia for discussions on policy and objectives, at a time to be agreed."

The MOD believe there are some good opportunities in Saudi Arabia. The intention is to arrange some industrial missions but the details are undecided. MOD officials intend to contact Mr Benjamin and Mr Baker in PEP to get discussions moving.

In view of Mr Heseltine's reply to Mr Walker's minute, I do not think there is any need for the Secretary of State to intervene in the correspondence.

MFD

MISS M F DAVIS

CODE 18-77

23 CCNO

MO 5/3/3V

NBPM
(Mr. Heseltine has spoken to her.)

CDP
27/9.

DN to see.

PRIME MINISTER

SALE OF AIRCRAFT TO SAUDI ARABIA

I have seen the Secretary of State for Energy's minute to you of 25th September.

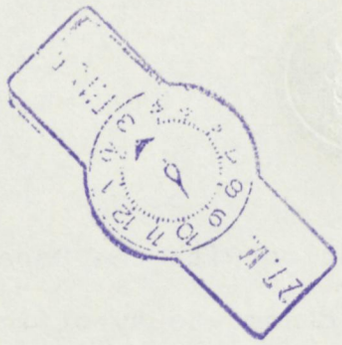
2. You will recall that, because of Saudi sensitivities, you directed at the beginning of the year that the negotiations surrounding this possible purchase should be kept to a very limited circle. This has made, I accept, for less than ideal handling within the Government but it might have been the case that with more normal arrangements the deal would have slipped away from us - as at one time seemed very likely. It is also the case that the full extent of the Saudi interest in paying for the deal by oil has emerged only at a very late stage in the discussions.

3. Having said this, I entirely accept the Secretary of State for Energy's underlying point. It would frankly have been better if his officials had been brought in as the final package emerged. This has now been rectified and the proposals which we have put to the Saudis on the oil element of the deal have, of

course, been prepared in full consultation with the Department of Energy. I attach considerable importance to my officials keeping in close touch with the Energy Secretary's officials over the coming months as well as working closely with the oil companies themselves.

4. I am copying this minute to the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, the Secretary of State for Trade and Industry and the Secretary of State for Energy.

Ministry of Defence
26th September 1985



Oil Prices: Energy Pltz

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INFO SAVING ALGIERS, QUITO, LIBREVILLE, JAKARTA, TEHRAN, BAGHDAD, BIS TRIPOLI, LAGOS, CARACAS

JEDDA TELNO 427: SAUDI OIL POLICY

SUMMARY

1. KING FAHD SAYS SAUDI ARABIA, LIKE OTHER COUNTIRES, WILL IGNORE OPEC PRICE AND PRODUCTION LIMITS IF IT CONSIDERS THIS NECESSARY TO PROTECT ITS INTERESTS.

DETAIL

2. IN THE COURSE OF A QUESTION-AND-ANSWER SESSION AFTER A SPEECH DELIVERED TO STUDENTS AT THE (ISLAMIC) UMM AL QURA UNIVERSITY IN MECCA ON 22 SEPTEMBER, KING FAHD WAS AKSED ABOUT OIL POLICY. HIS SOMEWHAT RAMBLING REPLY HAS BEEN WIDELY REPORTED HERE.

3. HE SPOKE AT LENGTH ABOUT SAUDI ARABIA'S EFFORTS AND SACRIFICES OVER THE YEARS TO FULFIL THE AIMS OF OPEC. IT WOULD STILL BE BEST IF FIRM AND BINDING AGREEMENTS ON PRICES AND PRODUCTION COULD CONTINUE. THE KINGDOM HAD DONE WHAT IT COULD. BUT SAUDI ARABIA WAS ONLY ONE MEMBER STATE AMONG MANY AND COULD NOT DO THE IMPOSSIBLE ALL BY ITSELF. OTHER COUNTRIES, IMPELLED BY SPECIAL CIRCUMSTANCES AND NEEDS, HAD LOWERED THEIR PRICES, INCREASED PRODUCTION, AND SOLD OIL BY BARTER. SAUDI ARABIA WAS NOT THEIR MENTOR, HAD NO RIGHT TO QUESTION THEM ABOUT THEIR DECISIONS, AND WOULD NEVER INTERFERE IN THEIR AFFAIRS. BUT SAUDI ARABIA WAS IN SIMILAR CIRCUMSTANCES, HAD SIMILAR NEEDS AND ENJOYED THE SAME FREEDOM OF ACTION IT RECOGNISED IN OTHERS. THE KINGDOM HAD NO RESOURCE BUT OIL. AS HE HAD ASKED YAMQI TO MAKE CLEAR AT THE LAST OPEC MEETING, IF SAUDI ARABIA WAS OBLIGED TO TAKE SIMILAR DECISIONS TO SECURE ITS NEEDS, HE WOULD NOT ALLOW OTHER COUNTRIES TO QUESTION THIS.

/COMMENT

RESTRICTED

COMMENT

4. THIS IS THE CLEAREST STATEMENT WE HAVE YET SEEN ABOUT SAUDI ARABIA PUTTING ITS OWN INTERESTS BEFORE COLLECTIVE INTERESTS. TAKING INTO ACCOUNT THE TONE AND EMPHASIS OF WHAT THE KING SAID, IT COMES CLOSE TO A PUBLIC ADMISSION THAT SAUDI ARABIA HAS NOW AGREED NET-BACK ARRANGEMENTS.

GREEN

STANDARD (~~PALACE~~)

ESSD
ERD
TRED
ECONOMIC ADVISERS
ECD'S
MED
NENAD
SAMD
MCAD
WAD
SEAD
WED

MR JOHNSON
MR EGERTON

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OIL

SECRET Copy No [redacted] of 7

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PRIME MINISTER

Now closed, 40 yrs, FOI Ex. Sch. 93
C Wayland, 10/3/16

I was surprised that I was not consulted about the implications for the oil market of the proposed Saudi purchase of aircraft, which I heard about for the first time only 10 days ago. I only learned about the oil aspects of the deal from the weekend press.

The quantities of oil which will be needed to pay for this deal could have a major impact on the oil market, however carefully handled. The rapid fall of around $2 in the market in July 1984 simply on the rumours of a large Saudi barter deal involving Rolls Royce and Boeing illustrate this.

At the moment the oil market is reasonably firm. Other things being equal there are a number of factors that point to it remaining so in the period immediately ahead, eg stocks are very low, the intensification of the Iraqi attacks on Kharg and hopes for a cold winter. But this fragile balance could very easily be upset and the market could well be very weak indeed in the 2nd and 3rd quarters of 1986.

I understand that MoD and British Aerospace have been talking to the Saudis in terms

BP and Shell have made it quite clear that there can be no question of their absorbing anything like this quantity in their own systems,

To go above this figure would run the risk of seriously undermining the market. The companies are no keener to push down the oil price through mishandling the flow of oil than I imagine the Exchequer is. Every $2 fall would

cost the Exchequer about £1bn in 1985/6. At the limit our loss in oil earnings could exceed the value of the order. Shaikh Yamani shared this concern, when the new Chairman of Shell saw him in Saudi Arabia over the weekend. I am not at all clear about the imperatives for proposing such a high level of sales, other than internal Saudi considerations.

The fact that a representative of the new Nigerian President has recently raised, on a very private basis, with Sir Geoffrey Howe the possibility of a major deal involving payment in oil simply heightens my concerns.

The incident raises a major question about how such decisions as these are handled within the Government. Clearly the issues I have raised here would have been better raised at an earlier stage in the formulation of the deal. Can I take it that for the future, where deals such as this are contemplated, which have an energy policy aspect, I will be closely consulted at an early stage.

I am sending copies of this minute to the Chancellor, the Foreign Secretary, the Secretary of State for Defence and the Secretary of State for Trade and Industry.

SECRETARY OF STATE FOR ENERGY

25 September 1985

SECRET

Foreign and Commonwealth Office

London SW1A 2AH

23 September 1985

Dear Charles,

Nigerian Debts: Oil

I understand that in a letter to the Prime Minister about the Tornado deal the Secretary of State for Energy has referred to a Nigerian proposal, put privately to Sir Geoffrey Howe in Lagos, that outstanding ECGD debts might be settled by the Nigerians in oil.

You will want to be aware of the details: I therefore enclose as background a copy of Ewen Fergusson's letter of 17 September to Gill in ECGD. But I should stress that this idea of President Babangida's is being examined on a purely hypothetical and exploratory basis. We are in no way committed to it.

I am copying this letter to Geoff Dart (Department of Energy).

Yours ever,

Colin Budd

(C R Budd)
Private Secretary

C D Powell Esq
10 Downing Street

SECRET

Foreign and Commonwealth Office

London SW1A 2AH

17 September 1985

J Gill Esq, CB
Export Credits Guarantee Department
POB 272 Aldermanbury House
LONDON EC2P 2EL

Dear Gill,

RELATIONS WITH NIGERIA

The Foreign and Commonwealth Secretary paid a rapid visit to Nigeria on 10 and 11 September, with the purpose of making contact with President Babangida's new Government and of getting our relations back on to a more normal footing. As background I enclose a copy of the Post's general reporting telegram (Lagos telegram No 925 of 12 September).

During his visit, which coincided with the announcement of the new Nigerian Council of Ministers, Sir Geoffrey Howe was able to have a short, rather public, meeting with President Babangida. At the President's request however, an entirely private and undisclosed meeting was held with Major-General Yar'Adua, a senior military figure, a Northern Nigerian, and still a significant influence within Nigeria.

At the meeting General Yar'Adua was clearly briefed by President Babangida to emphasise the President's wish to restore the warmth of Anglo-Nigerian relations, whatever hestitations had been expressed during the programme of talks.

It became clear that the prime purpose of the meeting was to address the economic situation in Nigeria, about which (understandably) President Babangida was very worried. He had no illusions about the difficult choices which faced him. He was particularly concerned about the enormous weight of ECGD short and medium term debt, mounting to some £700 million. President Babangida wanted to put forward a personal suggestion which had not been discussed with any other Nigerian Ministers or officials. He very much hoped that we would be prepared to consider a formula which would effectively enable the ECGD debt to be repaid through supplies of oil from Nigeria. The formula might be on the lines that the Nigerian Government would supply oil to the oil companies, who would then open letters of credit using oil as collateral: the Nigerian Government would then allocate the finance made available to the repayment of ECGD debts. President Babangida had not worked out a detailed scheme and there might be various ways in which this could be done. President Babangida hoped that we would consider it and then let him have a response on the same entirely unofficial channel without involving any other Nigerian Ministers of officials.

/Sir Geoffrey

Sir Geoffrey Howe said that we would obviously need to consider the proposal and he could not give an immediate response. Instinctively, he had to point out that ECGD basically preferred money, and that there could be no question of ECGD taking any risks on oil prices. He would obviously need to consult experts back home before giving a response. But we would come back to him when we had had time to consider the proposal.

There are a number of large question marks over this approach. Given the appointment of a new Finance Minister, Dr Kalu i Kalu, and the prospect that Nigeria may now be prepared to move towards discussions with the IMF, which if successful would help to unlock new credit arrangements, it is not clear why President Babangida is using this back channel. We know, however, that there is widespread opposition in Nigeria, partly because of the many vested interests involved, to the IMF's requirement of a substantial de-valuation of the Naira; the presumption must also be that the President fears that he might not be able to get his colleagues to agree to this proposal relating to Nigerian oil. Sir Geoffrey Howe recognised that we must look at the idea with considerable caution. It is clear that President Babangida attaches importance to it and if it helps him it could provide a significant boost to Nigerian stability and to our future relations. How far would it help ECGD? What are the practical implications? How far would it affect relationships within the Paris Club? How far would it cut across Nigerian relations with the IMF? What would the mechanics be? Who would handle the off-take of Nigerian oil? These are only a few of the questions which come to my mind. The Nigerians will be aware, of course, of the Tornado contract with Saudi Arabia and of our willingness, in particular circumstances, to do a deal involving oil.

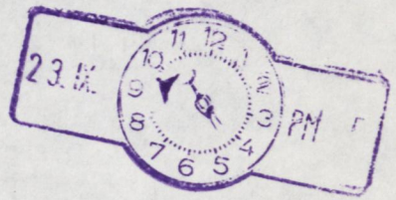
Sir Geoffrey Howe wishes to give as early a response to President Babangida as possible. Given the secrecy of the contact with Major-General Yar'Adua, and the possible implications for President Babangida if information about the suggestion, or our reaction to it, were to leak out, he has instructed that the circle of those knowing about the proposal should be kept to an absolute minimum. This accounts, therefore, for the classification which I have given this letter.

Since the proposal relates to the payment of ECGD debt, I am addressing this letter to you and am copying it to those who seem likely to have a direct interest. I should be grateful for your preliminary reactions as soon as possible. We can then consider further co-ordination in Whitehall and, as necessary, the preparation of a more detailed reply to President Babangida.

Yours ever,

Ewan Fergusson

E A J Fergusson


23. IX.
PM

2

CONFIDENTIAL

Prime Minister
Have questions than answers – which is fair enough.
DCS 20/9.

MR NORGROVE

20 September 1985

THE OIL MARKET

A normally twitchy oil market has been surprisingly unmoved by Saudi Arabia's decision to put another 1 million b/d of oil into the market at prices netted back from the spot prices for oil products. At least for the time being, Saudi Arabia has abandoned its role as OPEC's swing producer - defender of the balance between oil supply and demand, and underwriter of high oil prices.

While oil analysts see this as a watershed which significantly increases the possibility of an oil price collapse, our North Sea crude continues to trade at around $27 per barrel. Is this just the calm before the storm, or have the analysts got it wrong?

The psychology of the market is certainly bearish, but physically the market is tight, both in the US and Europe. Oil stocks are exceptionally low. With the northern Winter approaching, there is little scope for oil buyers to hang back in anticipation of lower prices. Thus, there may be room for an additional 1 million b/d of oil from Saudi Arabia over the remainder of this year. Additional exports are expected from Iraq's new trans-Arabian pipeline, but this may be offset by the Saudis selling less war relief oil on behalf of Iraq. The immediate outlook for Russian exports is for less rather than more.

CONFIDENTIAL

The game of poker between the oil producers looks like getting particularly tense as we move into the new year. Do the Saudis really mean to test the collective will and nerve of their fellow OPEC members? Are they hoping that fear of an international financial crisis will at last galvanise non-OPEC producer Governments into some measure of support? Or having secured a larger share of the Winter oil market, will the Saudis be prepared to back off and absorb much of the Spring/Summer downturn?

Although no producer can expect to win from a scramble to offset falling prices by unwanted additional production, some analysts now doubt that the widely divergent standpoints of the Nigerians, the Saudis, the Iraqis and the Iranians can be reconciled without the trauma of a price collapse. The OPEC meeting early in October should give some clues.

Meanwhile, we are unlikely to see a hasty reduction of exploration and development activity in the UK. The principal determinant here is the outlook for oil prices in the 1990s, which are seen as less influenced by this Winter's poker game than by long-term trends of supply and demand.

My guess is that OPEC will continue to muddle through, with oil prices weak but not collapsing.

JOHN WYBREW

PA.

MR NORGROVE

13 September 1985

THE OIL MARKET

The oil market is buzzing with speculation and rumours that Saudi Arabia is concluding new "netback deals". Under these, they would sell upwards of 1 million b/d of additional crude oil at a price netted back from the prevailing spot market prices for oil products. Such deals are attractive to the oil companies and the Saudis would have no difficulty in finding ready customers.

Does this mean that Saudi Arabia has abandoned its role as OPEC's swing producer - the means by which supply is kept closely in line with demand and oil prices are held artificially high? My information - especially from Petroleum Economics Ltd, a reputable firm of analysts who have high-level contacts in the oil companies and OPEC - tends to confirm such a policy change.

The Saudis have had a fundamental rethink and concluded that their fast shrinking share of OPEC production - at times below 2 million b/d - is unacceptably low. They aim to re-establish and then defend a production level of at least 3½ million b/d. They see netback deals to integrated oil companies as the least disruptive way of achieving this. They will argue that in theory, provided the other OPEC members share the burden of balancing supply against demand, netback deals need not entail a discount off official prices.

Some experts still see this as a threat rather than an accomplished fact - the Saudis putting pressure on other OPEC members before the OPEC meeting early in October. But this hope is belied by the fact that Exxon has already chartered five large tankers and Mobil and Texaco are rapidly withdrawing from alternative crude oil sources.

Exceptionally low oil industry stocks and a seasonal pick-up of oil demand may allow sufficient room for the higher Saudi production to be accommodated in the fourth quarter without undermining oil prices. But unless the other OPEC members genuinely achieve a greater measure of self-discipline than hitherto, the Spring of next year will see world oil production significantly in excess of demand and prices sliding fast.

The Saudis do mean to test the collective will and nerve of their fellow OPEC members.

JOHN WYBREW

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26 July 1985

PRIME MINISTER (2)

AT 26/7

THE OIL MARKET AFTER THE GENEVA MEETING

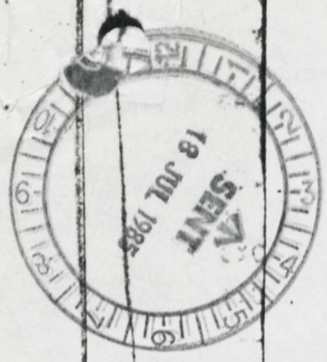
OPEC are still muddling through. True to form, Saudi Arabia was not moved to unilateral shock treatment so as to persuade the other members to shoulder more of the burden of reducing production. The minor adjustments of price differentials achieve nothing. Only tighter control of OPEC production can prevent a continued slide of oil prices.

North Sea oil prices are currently around $27 per barrel. For the next month or two, oil prices will probably remain firm as buyers catch up after holding back prior to the OPEC meeting. At least that is satisfactory news for the Britoil flotation.

It is probably wishful thinking for OPEC to believe that thereafter they will benefit from the approach of the northern winter and the pick up of oil demand. Oil demand remains weak, especially since the US economy is slowing down. The recent drop of gasoline prices in the US is a significant pointer. Other negative factors are the build-up of North Sea production after summer maintenance, and Mexico's intention to produce more. Having failed to win formal accommodation from the other OPEC members, the Saudis are likely to increase their oil exports using back door arrangements such as their trading organisation NORBEC.

This portends a fall of oil prices in the autumn. The sharper it is, the more hope the Saudis have of persuading the others to face up to the need for an effective, equitable method of production control.

JOHN WYBREW



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MY TELNO 431 (NOT TO ALL) : SAUDI OIL POLICY

SUMMARY

1. YAMANI FORECASTS FAILURE AT THE FORTHCOMING OPEC MEETING, LEADING TO AN ABANDONMENT OF QUOTAS AND THE EFFECTIVE BREAK-UP OF OPEC FOR THE TIME BEING. HE EXPECTS A GRADUAL, BUT POSSIBLY DRAMATIC, INCREASE IN PRODUCTION BY SEVERAL PRODUCERS, INCLUDING SAUDI ARABIA, LEADING TO A SHARP DROP IN OIL PRICES.

DETAIL

2. I CALLED ON THE SAUDI OIL MINISTER IN TAIF ON 17 JULY. SHAIKH YAMANI WAS STILL RECOVERING FROM THE VIRUS WHICH PREVENTED HIM FROM PARTICIPATING IN THE VIENNA OPEC MEETING EARLIER THIS MONTH, AND HAD SOME DIFFICULTY WITH HIS VOICE. HE NEVERTHELESS SPOKE FOR ABOUT HALF AN HOUR.

3. YAMANI SAID THAT HE WOULD BE LEAVING FOR THE EXECUTIVE COMMITTEE MEETING IN GENEVA ON 20 JULY, BUT THAT HE SAW NO PROSPECT OF ANY SATISFACTORY OUTCOME TO THE OPEC MEETING ITSELF. THE INEVITABLE RESULT WOULD BE ABANDONMENT OF OPEC QUOTAS

PROSPECT OF ANY SATISFACTORY OUTCOME TO THE OPEC MEETING ITSELF. THE INEVITABLE RESULT WOULD BE ABANDONMENT OF OPEC QUOTAS, LEADING SOONER OR LATER TO A SIGNIFICANT FALL IN PRICES. SAUDI ARABIA HAD THE CAPACITY TO INCREASE HER OUTPUT TO 9 MBD, OR EVEN MORE, WHICH SOULD LEAD TO A DROP IN OIL PRICES AS LITTLE AS DOLLARS 10. HE DID NOT EXPECT THIS TO HAPPEN IMMEDIATELY, BUT A GRADUAL MOVE IN THAT DIRECTION WAS, IN HIS VIEW, UNAVOIDABLE.

4. I ASKED HIM WHETHER ANY OF THE PROPOSALS WHICH THE PRESS HAD REPORTED FROM THE VIENNA MEETING (YOUR TELNO 306 WERE LIKELY TO SUCCEED. HE DOUBTED WHETHER ANY OF THEM WOULD BE EFFECTIVE. THE IRAQIS HAD PUT FORWARD THEIR DEMANDS FOR AN INCREASE IN THEIR OWN QUOTA, BUT NO MEMBER OF OPEC WAS PREPARED TO GIVE UP EVEN ONE BARREL OF OIL TO HELP IRAQ. THE IRAQIS WERE CLEARLY DETERMINED TO INCREASE PRODUCTION ANYWAY, AND THEIR PIPELINES THROUGH TURKEY AND SAUDI ARABIA WOULD LEAD TO QUITE A SIGNIFICANT INCREASE. I ASKED ABOUT THE PROSPECTS FOR THE YANBU PIPELINE. YAMANI REPLIED THAT IT SHOULD BE READY BY THE END OF THE YEAR, WITH AN INITIAL THROUGHPUT OF ABOUT 200,000 BD, RISING TO 500,000 BD NEXT YEAR. BOTH THE SAUDIS AND KUWAITIS WOULD OF COURSE STOP EXPORTING OIL ON IRAQ'S BEHALF (IE 180,000 BD FROM SAUDI ARABIA AND 123,000 FROM KUWAIT). BUT THE IRAQIS WOULD STILL BE WELL OVER THEIR QUOTA.

5. YAMANI ADDED THAT, HISTORICALLY, OPEC HAD ALLOWED IRAN AND IRAQ A JOINT QUOTA BETWEEN THEM. ALTHOUGH IRANIAN EXPORTS WERE STILL AFFECTED BY CUTBACKS IN THE SHUTTLE SERVICE TO SIRRI, THE IRANIANS WERE NO LONGER BEHAVING AS RESONSIBLY AS THEY HAD, AND WERE ALSO NOW PRODUCING OVER THEIR QUOTA. ON POLITICAL GROUNDS, THEY WERE ALSO STRENUOUSLY OPPOSING AN INCREASE IN IRAQ'S QUOTA.

6. YAMANI SAID THAT THE ALGERIANS HAD REVIVED AN OLD PROPOSAL AT VIENNA THAT AN OPEC MIX OF 2 TO 3 MBDBXXXXXXBXXXXXBXXXBXBXBXBXXXXX XXXXXXXXXXX

6. YAMANI SAID THAT THE ALGERIANS HAD REVIVED AN OLD PROPOSAL AT VIENNA THAT AN OPEC MIX OF 2 .59 3 MBD SHOULD BE SOLD ON THE SPOT MARKET AT A DOLLAR BELOW NORTH SEA PRICES. THE ALGERIAN MINISTER OF OIL HAD EVEN TOLD ONE OPEC COLLEAGUE AT VIENNA THAT ALGERIA WAS DETERMINED TO GO FOR A PRICE WAR, WHICH HE FOUND ASTONISHCG.

7. I ASKED WHETHER THERE WAS ANY PROPOSAL TO CHANGE THE SUADI MIX BETWEEN HEAVY AND LIGHT CRUDE. YAMANI SAID THAT SOME ADJUSTMENT IN THE PRICE OF HEAVY CRUDE MIGHT BE POSSIBLE, BUT OPEC HAD NOW PASSED THE POINT WHEN CHANGES OF THIS SORT WERE ADEQUATE TO DEAL WITH THE PROBLEM. I ASKED WHETHER HE WAS TALKING ABOUT THE BREAK-UP OF OPEC? YAMANI REPLIED THAT HE WAS, AT LEAST FOR THE TIME BEING. SAUDI ARABIA WOULD CONTINUE TO CO-OPERATE WITH HER OPEC PARTNERS, BUT SHE HAD DECIDED THAT SHE COULD NO LONGER BEAR THE BURDEN ALONE. IT SADDENED HIM THAT OTHER OPEC PRODUCERS WERE NOT PREPARED TO CO-OPERATE. HE ADDED,

COULD NO LONGER BEAR THE BURDEN ALONE. IT SADDENED HIM THAT OTHER OPEC PRODUCERS WERE NOT PREPARED TO CO-OPERATE. HE ADDED, WITH A SMILE, THAT OE SAME WENT FOR NON-OPEC PRODUCERS.

8. I ASKED YAMANI ABOUT THE ORIGIN OF THE STORY THAT THE AMERICANS HAD BEEN NOTIFIED THAT SAUDI ARABIA WOULD START PRODUCING AT 9 MBD. YAMANI SAID THAT IT APPARENTLY AROSE FROM SOMETHING WHICH THE UNITED STATES ENERGY SECRETARY HAD SAID TO THE NEW YORK TIMES AND THE WALL STREET JOURNAL IN PARIS, AND THAT HE HAD HIMSELF "HAD TO PUT OUT A DENIAL THAT WHAT THE SECRETARY HAD SAID HAD ANY BASIS OF TRUTH". HE COULD NEVERTHELESS TELL ME "AS A FRIEND" THAT HE EXPECTED THIS TO HAPPEN. WHEN I ASKED WHETHER SAUDI ARABIA WOULD STILL KEEP TO ITS QUOTA OF 4.35 MBD, HE REPLIED "THERE WILL BE NO QUOTAS NOW".

9. I ASKED WHETHER OTHER OPEC MEMBERS HAD COMPARABLE CAPACITY TO INCREASE PRODUCTION. HE REPLIED THAT BOTH IRAQ AND KUWAIT COULD INCREASE THEIR PRODUCTION LEVELS, AS COULD NIGERIA. VENEZUELA AND ECUADOR WERE ALSO VERY EXPENSIVE PRODUCERS, WHO WOULD BE VERY READY TO INCREASE THEIR PRODUCTION IF POSSIBLE. IN REPLY TO MY QUESTION, HE SAID THAT HE DID NOT THINK THAT THE KUWAITIS WERE CONCERNED ABOUT DEPLETION.

10. I ASKED FOR HIS ASSESSMENT OF THE EFFECTS OF LOW PRICES ON THE THIRD WORLD, COMMENTING THAT THE MAJOR OIL-PRODUCING DEBTORS WERE LIKELY TO SUFFER PARTICULARLY BADLY. HE AGREED THAT THE EFFECT COULD BE DRAMATIC, AS INDEED IT WOULD BE ON THE WHOLE INDUSTRIALISED WORLD. IT COULD QUICKLY LEAD TO A BANKING CRISIS IN THE UNITED STATES. BUT PRESENT SITUATION COULD SIMPLY NOT CONTINUE. I ASKED WHETHER HE EXPECTED A DEMAND FOR 9 MBD OR MORE. YAMANI REPLIED THAT STOCKS WERE AT PRESENT DANGEROUSLY LOW, AND THAT MANY COMPANIES WOULD BE READY TO BUY AT LOWER PRICES FOR THEIR STOCKS. WHEN I ASKED ABOUT THE EFFECT ON SAUDI FINANCIAL RESOURCES, YAMANI ADMITTED THAT THE ADVANTAGES OF QUADRUPLING PRODUCTION AT A THIRD THE PRICE WERE LIMITED: BUT THERE WOULD NEVERTHELESS BE SOME IMPROVEMENT.

11. I ASKED WHETHER THERE WAS REALLY NO HOPE THAT SOME MECHANISM COULD BE DEVISED TO STOP OTHER OPEC MEMBERS [illegible] THAT THE EXECUTIVE COUNCIL SHOULD KEEP AN EYE ON FRINGE DEALS, AND IT HAD BEEN AGREED THAT INDIVIDUAL MEMBERS SHOULD REPORT TO THE EXECUTIVE COUNCIL. BUT HE DOUBTED WHETHER THEY WOULD, OR WHETHER THE MECHANISM WOULD BE EFFECTIVE.

12. IN CONCLUSION, YAMANI SAID THAT HE HAD NO DOUBT THAT THE FIRST REACTION OF SOME PEOPLE TO OPEC'S COLLAPSE WOULD BE PLEASURE, BUT THAT ON REFLECTION MOST PEOPLE WOULD BE SAD AT THE PROSPECT. I SAID THAT I WAS SURE THERE WOULD BE NO REJOICING IN THE BRITISH GOVERNMENT, PARTICULARLY IF THE COLLAPSE OF OPEC LED TO A DRAMATIC FALL IN PRICES ON THE LINES HE HAD SUGGESTED. YAMANI REPEATED THAT THIS NEED NOT NECESSARILY HAPPEN QUICKLY, BUT HE WAS SURE THAT IT WOULD HAPPEN NEVERTHELESS. WHEN I COMMENTED THAT THIS MUST

NOT NECESSARILY HAPPEN QUICKLY, BUT HE WAS SURE THAT IT WOULD HAPPEN NEVERTHELESS. WHEN I COMMENTED THAT THIS MUST BE ONE OF THE MOST DIFFICULT POINTS IN HIS LONG CAREER, YAMANI REPLIED THAT THINGS BECAME MUCH LESS DIFFICULT ONCE ONE HAD STOPPED FIGHTING.

13. COMMENT: THERE WAS NO DOUBT AN ELEMENT OF FLESH-CREEPING IN WHAT YAMANI HAD TO SAY, ALTHOUGH (WITH THE ONE EXCEPTION OF HIS REFERENCE TO NON-OPEC MEMBERS IN PARA 7 ABOVE) HE NOTICEABLY REFRAINED FROM ANY RECRIMINATION OVER HMG'S POLICIES OR PRODUCTION LEVELS. THE EXTRAORDINARY CONFLICTS AND CONTRADICTIONS IN SAUDI PRESS TREATMENT OVER THE PAST WEEK OR SO (MY TUR) NO DOUBT REFLECT AN INTERNAL DEBATE HERE. BUT YAMANI CERTAINLY LEFT ME WITH THE IMPRESSION THAT HE IS RESIGNED TO AT LEAST THE TEMPORARY BREAK-UP OF OPEC AS AN EFFECTIVE BODY.

WRIGHT

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CCN LINE 0 THREE PARA 11
''CHEATING''. YAMANI SAID THAT IT HAD BEEN AGREED IN VIENNA THAT THE ETC

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PRIME MINISTER

You are well aware of the present weakness in the oil market and the difficulties which OPEC are having in agreeing cuts in their production. There is the risk of renewed pressure on North Sea producer governments to help by cutting production. BP and Shell have taken action temporarily to reduce production on their own initiative. There may however be pressure on the United Kingdom Government to reduce UKCS output in the following ways:

(i) by imposing production cuts;

(ii) by "banking royalty oil" ie by asking companies to reduce production by the 12½% royalty, saving it up to be produced for the Government at some later date.

For your information a background note on production controls is attached at Annex A. At Annex B there is a copy of a note prepared last year discussing a proposal made by Shell at the time for short-term royalty banking; Shell have recently revived this proposal (see interview with Mr Holmes in the Daily Telegraph for 1 July).

Action on either basis would be limited in scope. Production controls might make it possible to cut back output to the extent of something less than 360,000 bd, 13% of current production. But formally at least 6 months' notice is required, although the licensees might be persuaded to waive this. Royalty banking could be more immediate in effect but its effect on production would be limited to a maximum of 250,000 bd and would need the co-operation of the licensees for its implementation. But although the effect on the amount of oil entering world markets would be marginal, the financial effects for the Exchequer would be substantial. A 13% reduction in output through production controls would cost the Exchequer about £2 billion. Royalty banking up to 250,000 bd would also cost about £2 billion.

10 July 1985

P W

SECRET

PRODUCTION CONTROLS

Background Note

1. Under the terms of petroleum production licences oil can be produced only with the consent of the Secretary of State for Energy. A production profile is negotiated as part of the development plan. The Department insists on a stringent interpretation of the requirements of "good oilfield practice" ie minimising risks of damage to the reservoir or of reducing ultimate economic recovery. Operators often seek production increases as development work improves knowledge of the reservoir characteristics, but this is not always agreed; sometimes the consent level is reduced. Consent levels are averages for the period, and there are no controls on daily or monthly production as such. But production has on occasion had to be reduced or shut in in order to remain within the consent.

2. About half of UK production comes from fields covered by short term consents, usually of 6 months' validity. These cannot be varied during their term without the licensees' agreement. Other fields have longer term approvals or consents. In most cases these can be varied after an initial period of immunity, but 6 months' notice must be given, cuts are limited to 20% at most and the SoS must consider any representation made by the licensees on relevant technical or financial matters. A few small fields have long term consents which cannot be varied.

3. In addition to legal constraints, Ministerial assurances have been given on the possible incidence of production cuts. These limit cuts to 20% at most, even where that is not a legal requirement. In some fields, even 20% might damage long term recovery and would not be attainable in practice. Also, all fields are assured of an initial immunity period, typically 4-5 years.

4. Overall it should be possible to impose cuts, on 6 months' notice, to the extent of something less than 360,000 b/d (13% of current production). This might be increased by something less than 60,000 b/d by the end of 1986. The constraints are essentially legal, and are only marginally increased by the assurances.

5. It may, however, be possible to reach agreement with the companies (who have an interest in avoiding large price falls) to accept cutbacks much sooner than 6 months. In particular they may be willing to agree to a deal whereby they accept, say, a 10% cut immediately rather than a 20% cut after 6 months. At this stage, it is only surmise that they may be prepared to agree to such a deal.

SECRET

ANNEX B

→ 82/92/1

ROYALTY BANKING

The Shell Proposal

1. Shell have suggested that HMG implement short-term royalty banking, in order to take some oil off the market to reduce current pressures. They have worked out how this might be done in respect of their own fields, on which the current level of royalty is around 80,000 b/d. They would propose to cut production in the Brent field by 75,000 b/d in August (relative to the consent level: production will be about 60,000 b/d down in any case for maintenance) and by 85,000 b/d in September. Repayment could be obtained by increasing production above the consent level by 27,000 b/d for the succeeding six months, or 53,000 b/d for the last quarter of 1984 only.

2. This note assesses the technical and administrative feasibility of the proposal, and touches on the implications of extending the approach to other UKCS fields and licences. The objections to royalty banking more generally, which would include longer-term banking arrangements where the period of repayment was not necessarily known in advance, were mentioned in the Government memorandum on depletion policy (Select Committee on Energy: July 1982). Royalty banking, it noted, involved certain costs and potential risks for the Government, associated with the lack of incentive for companies to recover the banked oil when fields are in decline; it was not, therefore, an acceptable option.

Technical Aspects

3. Shell are confident that even the higher production rate required for the shorter of the two possible cycles (two months' banking, three months' payback) is within the capacity of the Brent field, topside facilities and pipelines; and that there would be insignificant risk of damage to the reservoir or to long-term recovery. PED agree. The swing in production would also affect gas production from Brent, but Shell have checked that the variation is within the range allowed by their contract with BGC.

4. Shell believe that there is more limited scope to increase production in Fulmar and perhaps North Cormorant, if this were needed because of unexpected problems with Brent. They prefer to accomplish the whole swing in Brent, but the Fulmar and Cormorant possibilities give additional assurance that any banked oil could be recovered.

5. PED have made a preliminary assessment of whether similar swings would be possible in /other major fields. The general conclusion, which may be slightly modified by the separate examination of BP's proposal to swing Forties and Magnus,

/the

is that that degree of flexibility is not available in most cases. Maintenance apart, all these fields are planned to produce at or near consent levels for the next 6-9 months, and close to technical capacity. Increases in production to achieve repayment of banked oil would not be possible. (Magnus, which figures in the BP proposal, was not included in this assessment). I suspect that PED have, properly, erred on the side of caution, and detailed discussion with the operators might uncover some more limited scope. But there would be serious objections to production increases in at least three major fields (Ninian, Claymore and Thistle) and there is less scope in Forties, now off plateau and declining, than in Brent. (Shell have said that the present flexibility in Brent will be gone in a couple of years time).

6. It seems safe to conclude that the maximum technical scope on the UKCS, outside Shell/Esso production pivoting on Brent, will be well short of the possibility of banking royalty for two weeks, even if six months are allowed for recovery.

Administrative and Legal Aspects

7. Administrative and legal problems would be minimised in Shell's proposal by swinging only one field, within a single chargeable period, and by the fact that only two companies need be consulted. Except BP (in respect of Magnus and perhaps Forties) any other case would be more complicated.

8. The main administrative problem however does apply to Brent. This is the need to suspend or modify the effects of parts of the model clauses, relating to the taking of royalty. The technically correct form for this is a deed of variation, but Legal Branch advise that an exchange of letters is acceptable, providing it is clear and comprehensive. The problem is that there would be little time to set up these arrangements. We could not be absolutely sure that the alternative arrangements were truly comprehensive, or even that they could be unambiguously interpreted, and we should have to depend on the co-operation of the companies to solve the many practical problems that might be expected to arise. Full commitment of the company to the success of the exercise would be essential, so that we do not run excessive risks of the exercise floundering in disputes or at worst even litigation.

9. In the Shell proposal, we should have to be assured of Esso's commitment, which is lacking at present. But Shell, as promotors of the idea, ought to be committed.

10. If royalty banking were sought from fields more diversely owned, or simply more divided, it would be progressively more difficult to attain a reasonable assurance of the necessary degree of commitment. The extreme would be Claymore with 17 licences ranging from Texaco to Pict, all of whom have some

say in the field. (In Forties the farmors have no effective voice). The risks of relying, even in part, on informal co-operation must be greatly increased in such a field. A similar problem with different overtones arises in Murchison because of the participation of Norwegian licences.

11. In the Shell proposal, all the swings are within a single consent period, so no variation of the consent is needed (the consent is to average production over the period, and there are no explicit controls on the rate for shorter periods). If in other cases the repayment period runs into that of the next consent, there is no obvious difficulty in varying the new consent level suitably (and, where necessary, any flaring consent).

12. Other than in Brent, it might not be acceptable to recover the banked oil in as short a time as three months, and the repayment period would extend into the next chargeable period. This would require still more radical suspension or amendment of the current effects of the model clauses. We have not identified any obviously serious problems in this, but the number of detailed points on which we would have to rely on informal co-operation would be increased, and likewise the risks of divergent approaches or dispute.

13. Shell have an administrative problem of their own. There is a computer programme (BOLS) which allocates lifting rights at Sullom Voe between the Brent system participants. The main programme can cope with royalty banking, but subsidiary programmes, which produce reports on profile of entitlement, royalty schedules and other matters, will not. Quite a lot of manual amendment and re-drafting would be required. It seems more an inconvenience than an obstacle; Shell accept this.

Financial Aspects

14. The main financial impact is on HMG, and appears as extra interest costs through delayed receipt of royalty oil. Shell's proposal is actually royalty banking in Brent, coupled with a production swing in Brent which offsets the volume of RIK taken from their other fields. Shell might propose compensation for the production swing. But they were planning maintenance work in August anyway which would have cut production by an amount conveniently equal to the production swing, and we should certainly refuse compensation for that. If the genuinely incremental cut were taken as being all royalty, the interest cost to HMG is about £1½ m over the five months (average) until the oil is recovered.

15. There are other costs which the companies might seek. HMG pays the companies delivery and treatment costs on RIK, which average around 10% of the value of the oil, and these

are paid pretty promptly on lifting. Shell have suggested that we continue to pay D & T costs even if we bank the oil, as these are largely (80%) fixed costs which they continue to incur. So far as Shell alone is concerned, this could probably be rejected. Since they have suggested that HMG makes a major sacrifice, it is hardly unreasonable to ask them to bear a small part of the cost (around £75,000 extra interest charges). But since Esso are less than enthusiastic, it might be necessary to swallow this additional cost in order to obtain their co-operation; and we should then have to concede to Shell also. This would apply more widely if we seek banking in other fields.

16. As well as bearing most of the cost, HMG would bear most of the risk that the oil price falls and the banked oil is worth less when it comes to be sold. As an abstract possiblity, the time exchange of royalty oil could be made as an exchange of value rather than volume; and Shell expressed anxiety that we would require more barrels if the price fell. The administrative problems would be multiplied many times if we did. As the companies, not HMG, would then bear the price risk, we should certainly lose Shell's co-operation and disputes would be almost inevitable. I think we would have to accept that HMG would take the price risk on the banked royalty.

17. In suggesting royalty banking, Shell were assuming that it could be implemented industry-wide. If, as seems likely from the above, there are only a few cases, including Shell/Esso, where it is technically and administratively acceptable, Shell and the other "possible" companies would be nervous about finding themselves meshed into a different set of legal and contractual relationships with HMG from the companies outside the net. If royalty banking in Brent were regarded as an alternative, for Shell/Esso only, to storage, it would probably be necessary to offer nominal storage charges as well as D & T costs, notwithstanding that the banked oil is less flexible and less certain than the stored oil.

18. If we were to seek implementation of royalty banking on an immediate basis, BNOC would have to unwind its forward commitments on the oil in question (typically six weeks ahead). On Brent, this is not a serious problem, since the oil should be sold to Shell anyway, as RIK sale-back. In other cases, BNOC's practical flexiblity in scheduling liftings should absorb much of the problem but BNOC might in some cases have to repurchase oil, with some risk of additional losses if the market had firmed. There is also a risk of demurrage charges if tankers are rescheduled and miss the appointed slot. The extent of these costs can only be estimated after discussion with BNOC.

Conclusions

19. There are no technical objections to Shell's proposal. Many administrative problems are simplified by the shorter

of the two repayment schedules proposed. The need to rely at least in part on the co-operation and commitment of the companies involved could be acceptable in this context, providing we have reasonable assurances of co-operation from Esso.

20. Other than Brent, there are few, if any, large fields where the necessary degree or production swing is technically acceptable for short-term banking of this kind. The total scope on the UKCS will fall well short of uniform application of royalty banking, probably much nearer 100,000 b/d than the total RIK flow of 250,000 b/d at present.

21. Even where technically acceptable, royalty banking even on a short-term basis may be administratively unacceptable because the complexity of the licence holding, diversity of interests of the licence holders, or presence of foreign licensees make it impossible to be confident of a sufficient commitment to co-operation and the solving of practical problems. Selective implementation of royalty banking might be unwelcome to the companies in the few cases where it might be acceptable to us.

PRIME MINISTER (2)

28 June 1985

THE OIL MARKET

It is less than a week to the OPEC meeting, and the oil markets are a good deal more calm and settled than our weather. North Sea oil and the most widely-traded US blend of crude are selling at around $27 per barrel. Does this imply market confidence in a stabilising outcome of the OPEC meeting?

It certainly doesn't imply an easy meeting. With the underlying demand for OPEC oil still trending gently down and the sharing of the misery now far removed from the official production quotas, there is a pressing need to realign quotas around a lower total. That will also entail some adjustment of the price differentials between light and heavy crudes. Resolution will be difficult, with long-suffering "haves", like Saudi Arabia, arguing that the burden is intolerable and "have nots", like Nigeria, pleading economic necessity. Agreement is unlikely to be attainable at the first meeting. A series of meetings may be necessary before such differences can be reconciled.

Normally, this type of stalemate would induce nervous buyers to hold back and wait for an outcome. Such a stand-off is usually reflected in sharply-falling oil prices with doomsters foreseeing an oil price collapse. Currency markets have a nasty habit of picking up the same jitters.

This time round the traders' instincts will be similar, but the underlying physical reality should be more of a stabilising factor. Of late, world oil production has not exceeded demand - mainly because the high-priced OPEC crudes have not attracted customers. World oil stocks are exceptionally low, making it difficult for a prolonged stand-off of would-be buyers. In the dominant US market, supply, demand and stocks of oil products have been nicely in balance.

OPEC watchers see them reaching a workable outcome - with difficulty. Oil markets will shudder, but not as badly as last winter. In any event, sterling should be less jittery.

JOHN WYBREW

Prime Minister ②
AT
7/6

CONFIDENTIAL

MR TURNBULL

7 June 1985

OIL PRICES

It looks as if BNOC's suppliers will be receiving around $1.25 per barrel less for their North Sea oil in June than they realised in May. Six months ago, that would have caused deep foreboding in the oil industry and sent shock waves through the foreign exchange markets. Recent soundings indicate that the oil companies are nervous, but not profoundly so. The sterling/dollar exchange rate fluttered on oil price fears, but has not gone into a nosedive.

Why the relative calm? The elimination of the BNOC clearing price as a touchstone of oil market pressures and sentiment, provides part, but not all, the answer. The underlying physical picture has not improved as far as OPEC's efforts to hold up oil prices are concerned. Medium-term world oil demand forecasts have, if anything, been shaded down over the last 6 months. Factors such as the foreseen turndown of the US economy and the conversion of some southern European power stations from oil to gas, have contributed. The anticipated peaking of non-OPEC oil production is now seen as slipping from 1985 to 1986. OPEC members will have to keep their belts tight for at least another year.

No-one, including OPEC, seriously expects the non-OPEC producers to curb their production, even if oil prices fall.

CONFIDENTIAL

No-one foresees a further slide of oil prices restoring the growth of oil demand.

It is all on OPEC who, in spite of cheating by some members and sacrifices by others, doggedly maintain the balance of supply and demand. As before, there are good reasons why OPEC members could fall out in squabbling self-interest, leaving the oil price to spiral down. But the greatest self-interest lies in sticking together and patching up differences. That is likely to happen again and the markets anticipate it.

That may sound comforting, but the FSBR oil revenue forecast of £13.5 billion for 1985/6 looks like falling by upwards of £1.5 billion; the sterling price of oil is now subject to the twin pressures of weak dollar oil prices and stronger sterling.

JOHN WYBREW

UNCLASSIFIED
FROM JEDDA 300300Z MAY 85
TO ROUTINE FCO
TEL NO 321 OF 30TH MAY 1985
AND TO SAVING DEPT OF ENERGY, OSLO, KUWAIT, BAHRAIN, ABU DHABI, DUBAI, DOHA, JAKARTA, LAGOS, BAGHDAD, WASHINGTON AND CARACAS.

INTERVIEW WITH YAMANI : OIL

1. IN AN EXCLUSIVE INTERVIEW WITH 'SHARQ AL AWSAT' AND ITS ENGLISH LANGUAGE SISTER NEWSPAPER 'ARAB NEWS' WHICH APPEARED ON 28 MAY, THE SAUDI PETROLEUM MINISTER GAVE AN ASSESSMENT OF THE CURRENT STATE OF THE OIL MARKET AND MADE SOME PREDICTIONS ABOUT ITS FUTURE.

2. YAMANI'S MAIN POINT WAS THAT THE 1990S WOULD BE 'GOLDEN YEARS' FOR THE GULF PRODUCERS: BY THEN DEMAND WOULD HAVE INCREASED AND THE OPEC PRODUCERS WOULD HAVE A MONOPOLY OF SUPPLY, NON-OPEC PRODUCERS' RESERVES HAVING BEEN EXHAUSTED. LINKING THIS TO PRESENT POLICIES, YAMANI SAID ''THAT IS WHY THE KINDOM WILL DO ITS UTMOST TO PRESERVE MARKET AND PRICE STABILITY. WE WILL NOT EXPLOIT OUR LARGE RESERVES AND PRODUCTION CAPACITY TO PRODUCE AND SELL MORE, FOR THAT MAY HAVE WIDE-RANGING EFFECTS, LEADING TO AN INTERNATIONAL RECESSION AND HARMING US ALL.''

3. YAMANI'S MORE SPECIFIC POINTS WERE AS FOLLOWS:

(A) PRODUCTION AND PRICES. IN RESPONSE TO A SUGGESTION THAT SAUDI ARABIA MIGHT INCREASE ITS PRODUCTION TO 6-7 MBD AND CUT PRICES TO US DOLLARS 20/22 PB, YAMANI SAID THAT ALTHOUGH THIS WOULD INCREASE SAUDI ARABIA'S REVENUE, IT WOULD ALSO RISK INTERNATIONAL FINANCIAL CATASTROPHE, BECAUSE OF THE EXPOSURE OF FINANCIAL INSTITUTIONS IN COUNTRIES WHOSE REVENUES WOULD FALL SHARPLY IF PRICES FELL. HE THOUGHT THE PRICE FOR ARABIAN LIGHT WOULD REMAIN UNCHANGED AS THE DEMAND FOR IT WAS FIRM. ON THE QUESTION OF MONITORING OPEC MEMBERS' PRODUCTION LEVELS AGAINST QUOTAS, TANAMI SAID THAT THERE HAD BEEN INITIAL DIFFICULTIES AS SOME COUNTRIES THOUGHT SCRUTINY A DEPOGATION FROM THEIR SOVEREIGNTY AND AN INTERFERENCE IN THEIR INTERNAL AFFAIRS. ALL MEMBERS HAD NOW, HOWEVER, AGREED TO PRODUCE THE NECESSARY INFORMATION.

(B) STOCKPILING. YAMANI SUGGESTED THAT THE BUILDING UP OF LARGE STOCKPILES BY INDUSTRIAL CONSUMING COUNTRIES HAD MISLED OPEC IN PREDICTING FUTURE DEMAND AND SUPPLY LEVELS. THE LOW LEVEL OF THOSE COUNTRIES' PRESENT STOCKS WOULD CAUSE PROBLEMS FOR SUCH COUNTRIES IN THE FUTURE.

(C) ALTERNATIVE FUEL. YAMANI SAID GAS AND COAL WOULD NOT SERIOUSLY COMPETE WITH OIL BECAUSE OF THEIR HIGH PRODUCTION AND TRANSPORT COSTS, AND BECAUSE SUPPLIES COULD BE DISRUPTED (A MENTION OF THE MINERS' STRIKE HERE WAS HIS ONLY REFERENCE TO BRITAIN). HE ENVISAGED SIMILAR DIFFICULTIES FOR NUCLEAR ENERGY, INCLUDING QUESTIONS OF SAFETY. ''I DO NOT SEE IT BECOMING AN IMPORTANT SOURCE OF ENERGY IN THE COMING YEARS.''

(CD)

(D) PETROCHEMICALS. YAMANI SAID THAT SAUDI ARABIA HAD THE MOST ADVANCED AND EFFICIENT REFINERIES IN THE WORLD AND THAT MANY OF THOSE IN THE US AND EUROPE WERE OUTDATED AND INEFFICIENT. ''THESE REFINERIES SHOULD BE TAKEN OF PRODUCTION.''

4. COPY OF FULL TEXT FOLLOWS BY BAG.

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PRIME MINISTER

UK CONTINENTAL SHELF : PRODUCTION CONTROLS AND ROYALTIES

I have seen a copy of Nigel Lawson's minute of 7 May to you.

As was indicated in my Private Secretary's letter of 10 April, my understanding is that we agreed that any switch from royalty-in-kind to cash should take place in the longer term. Furthermore both the House and public opinion would consider that a very early change would call into question the case for setting up the new Agency. Indeed it would create severe difficulties for ourselves in Parliament to reveal such a step while the Oil and Pipelines Bill is going through Parliament. The fact that the run-down of BNOC has progressed very smoothly and that I have nearly completed the OPA Board makes it all the more important for us to avoid the unnecessary political obloquy of taking a step which everybody would represent as a volte-face.

Contrary to what Nigel suggests, RIK can make an important contribution to our security of supply. Given that RIK is sold spot, it can be deployed rapidly to enhance our security of supply, if a crisis blows up. Depending on when in the year the crisis occurred, it would take a minimum of 7-13 months to revert from RIC to RIK. As any supply crisis is likely to be limited, our ability to deploy RIK could make all the difference between keeping the market supplied and a politically damaging shortfall.

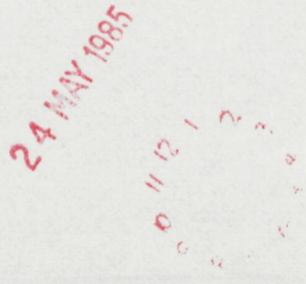
I am copying this letter to Geoffrey Howe and Nigel Lawson.

SECRETARY OF STATE FOR ENERGY

24 May 1985

SECRET

Energy: Oil Prices 42



Prime Minister (2)

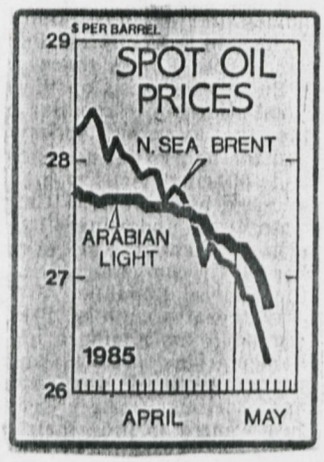
AT 10/5

10 May 1985

MR TURNBULL

OIL MARKET

The recent slide of the ~~Stock~~ Spot Market price for North Sea oil has led to renewed speculation that OPEC's official prices are under pressure.



In case the Prime Minister would like a comment, I have sought the views of BP, Esso, Shell and a leading independent analyst. This time round there is not the usual foreboding that the pressures for another downward adjustment of official prices are uncontainably building up.

There is still a close balance between world oil supply and demand, with Saudi Arabia for the first time having lowered its production below the current North Sea level. World oil stocks are close to minimum levels, implying that nervous buyers have little chance to hang back and live off stocks in anticipation of falling prices.

There is no prospect of OPEC members being able to relax their control over oil production for the remainder of this year or next. On the other hand, now that the official OPEC auditors are functioning, they do seem to be playing a useful rôle in holding the ring between individual OPEC members - if only as a neutral scorekeeper.

Interestingly, forward prices for North Sea oil do not show the familiar pattern of decline from current levels. If this is a measure of market sentiment, it reinforces the impression I am getting that we should see the recent oil price slide as a bout of the summer jitters, rather than the onset of a deep-rooted trend; today the North Sea spot price jumped 80 cents.

JOHN WYBREW

4.53

SECRET

Prime Minister (2)

To note AT 8/5

18

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

PRIME MINISTER

UK CONTINENTAL SHELF: PRODUCTION CONTROLS AND ROYALTIES

Geoffrey Howe sent me a copy of his minute of 3 April. I have also seen the letter of 10 April from Peter Walker's office.

2. I entirely agree with Geoffrey's assessment. OPEC countries have considerable scope for acting against us but, for all the reasons Geoffrey gives, I share his view that this should not lead us to adopt the sort of measures set out in the Annex to Peter's minute of 25 March.

3. I accept Peter's point that moving to royalty in cash is dependent on our ability to accommodate the adverse impact on the PSBR. I will be considering this in June when I will have the next Treasury economic assessment. We should need to give notice of such a change by 30 June if it were to come into effect from 1 January 1986. In the meantime I have asked my officials to examine possible ways of mitigating the adverse PSBR effects.

4. I do not see that such a change should create any concerns about security of supply. In his Statement on 13 March on the abolition of BNOC, Alick Buchanan-Smith linked our security of supply to the power to take royalty oil and this power would be preserved in any move to royalty in cash.

5. I am copying this minute to Geoffrey Howe and Peter Walker.

N.L.

7 May 1985

Energy: Oil Prices Pt 2.

SECRET

copy no: 1 of 4

17

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 7214

FIELDS

EJD
13/4.

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

10 April 1985

Dear Robin

Thank you for your letter of 26 March, which recorded a remit to my Secretary of State to consider, in consultation with the Chancellor, methods and timing of a move to take North Sea royalties in cash rather than in oil.

My Secretary of State will certainly pursue this matter. His understanding, however, is that it was agreed that any switch to cash should take place in the longer term, and when the Chancellor could accommodate the adverse impact this would have on the PSBR.

A very early change would call in question the case for setting up the new Agency, as announced to the House on 13 March. It would undoubtedly stir up fresh anxieties about security of supply which the Minister of State was at pains to allay at the time of the statement. It would also add to our problems with BNOC staff. The announcement about the Agency and its functions was, after all, agreed after careful consideration between the Treasury and the Department of Energy of the possibility of moving in the immediate future to cash rather than oil.

My Secretary of State will nevertheless be ready to review further the question of royalty oil once the new Agency has been successfully established and we have had some experience of their operations in this oil. And he certainly intends that the legislation should keep open the possibility of change.

I am copying this letter to Rachel Lomax and Len Appleyard.

Yours sincerely
Rachel Reidy

M F REIDY
Private Secretary

SECRET

ENERGY: oil : Pt 2.

10 APR 1985

SECRET

Copy no (1) of 2

16

Prime Minister (2)

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 7214

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

3 April 1985

Dear Robin

When the Prime Minister and my Secretary of State met Shaikh Yamani recently I believe Yamani mentioned that US oil reserves were equivalent to only 8 years of current consumption.

Proven oil reserves in the US are indeed worth only 8 or 9 years of current production (or about 6 years of current consumption). However, since 1918 such reserves have never been recorded at more than 17 years production and on average have been about 12 years production while production has increased 8 fold. "Proved reserves" are derived from company balance sheets. For tax and other reasons companies tend to understate reserves, and the US system does not permit central gathering of confidential reservoir information of the kind which is available to the UK Department of Energy. The effect is that the 8-year estimate does not mean much and is no basis for predicting future US production.

It seems probable that domestic US oil production will decline but it will not fall away suddenly and our own assessment is that the US will still be the world's second or third largest oil producer at the end of the century. Present US oil production is about 10½ million barrels a day. Projections for 1990 suggest a flat or gently declining rate. The IEA forecasts 6½ million barrels a day in 1995 at present real prices, or 8½ million at rather high prices.

Yours sincerely

Michael Reidy

M F REIDY
Private Secretary

SECRET

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2

Prime Minister - to see

This endorses the conclusions you reached with Mr. Walker and the Chancellor (a meeting which the Foreign Secretary did not attend).

TERB

3.4.

PM/85/25

PRIME MINISTER

UK Continental Shelf: Production Controls

1. Peter Walker sent me a copy of his minute of 25 March about his discussions with Shaikh Yamani. I have also seen your Private Secretary's letter of 26 March.

2. It was to be expected that OPEC would respond to our decision to abolish BNOC by attempting to engage the UK in their efforts to prop up the oil market through production restraint. Yamani's comments expand on arguments which he and other OPEC Ministers have also made publicly.

Mr. Walker asked for this

3. I attach an assessment of our exposure to possible OPEC retaliation against UK interests. While the OPEC countries have considerable scope for acting against us, this does not in my view constitute in itself a reason to adopt any of the measures listed in the annex to Peter Walker's minute. For us to introduce controls now would inevitably be interpreted at home and abroad as a signal that we were prepared to collude with OPEC in keeping oil prices high. This would cause considerable problems in our relations with the US, the rest of the Community and in the International Energy Agency. I imagine it would also bring new criticism in Parliament. Moreover, once we had admitted our ability and readiness to use such powers, we would be under continual pressure from OPEC - and also from consuming countries - to use them.

/4.

4. The political and economic arguments for introducing restraints would have to be very strong to outweigh this. As to the economic arguments, they were well summed up in Peter Walker's letter of 29 January 1984 to me; namely that to attempt to influence the balance of supply and demand through the control of UK output would be very costly, could damage confidence in North Sea investment and would work only if it appeared likely to clinch an OPEC pricing agreement. On the political front, the major decisions to abolish BNOC and to move to market prices have been accepted by OPEC with remarkably little criticism so far. Having extracted ourselves from the front line over pricing, we would need strong reasons to re-enter it over production. The likelihood of OPEC action against our interests is no such reason, at least at this point. Our policies on production are sensible and we should stick to them.

5. As to royalties, I would favour a move to take them in cash rather than in kind if the practical and revenue considerations so permit, since to do so would distance us even further from the market.

6. I am copying this minute to the Chancellor of the Exchequer and the Secretary of State for Energy.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
3 April 1985

The National Archives

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UK/OPEC TRADE RELATIONS*

1984

Exports to OPEC £6.4 bn

Imports from OPEC £2.4 bn

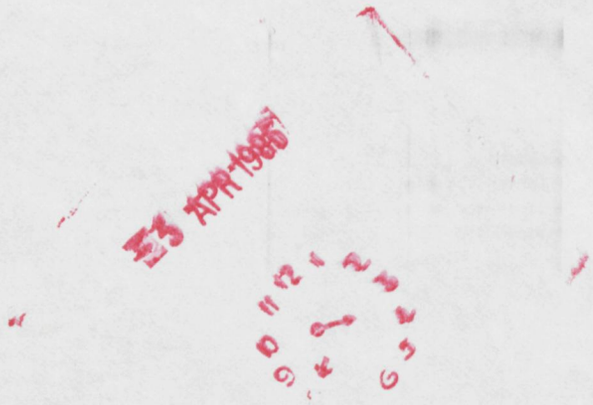
*(not including Gabon)

Saudi Arabia	Visible Exports	Imports	Principal Business Sectors	British Subjects
	1.3 bn	507 m	Defence sales. Telecomms. Power generation. Agriculture. Health care products.	35,000
Iran	703 m	368 m	Machinery and transport equipment. Chemicals. Health care. Raw materials (iron and steel)	70
Iraq	343 m	69 m	Machinery and transport equipment. Textile and metal goods. Health care products.	1,400
Kuwait	301 m	141 m	Electricity generation. Desalination and Sewage Construction. Health care.	5,800

Qatar	Visible Exports	Imports	Principal Business Sectors	British Subjects
	133 m	28m	Power generation. Electrical Health Care. Sewerage Constuction.	5,400
UAE	542 m	87 m	Construction. Power generation. Agriculture. Health Care.	7,100
Nigeria	614 m	253 m (Jan-Oct)	Defence sales. Agriculture. Health Care. Raw materials. Chemicals.	11,000
Algeria	287 m	274 m	Machinery and transport. Telecomms. Dairy products.	1,800
Libya	264 m	155 m	Construction. Capital plant. Health Care. Motor vehicles.	4 - 5,000
Venezuela	102 m	249 m (petroleum products 94% of total)	Whisky. Chemicals. Machinery. Dairy products.	2 - 4,000

Ecuador	Visible Exports	Imports	Principal Business Sectors	British Subjects
	34 m	13 m	Defence Sales. Power generating. Transport. Textiles.	550
Indonesia	186 m	181 m	Power generating. Machinery. Chemicals. Road Vehicles	5,000

ENERGY : Oil : Pt 2.



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of 4 copies

cc MASTER SET

10 DOWNING STREET

From the Principal Private Secretary

26 March 1985

Dear Michael,

At the end of a meeting on another subject this morning, the Prime Minister had a word with the Chancellor of the Exchequer and your Secretary of State about Mr. Walker's minute of 25 March on Shaikh Yamani's ideas about the current oil situation. Your Secretary of State said that if a cut of North Sea oil production by, say, 20% were to be effective in stabilising oil prices, he would be inclined to favour it. But it would be strongly criticised by both the American Government and European Governments which wanted cheaper oil. In any case, it was difficult to achieve any effective way of restraining North Sea oil production, and the suggestion put forward by Shell that the Government should forego its royalty oil would have serious financial consequences for the Government without damaging the oil companies.

In discussion it was suggested that there would be advantages in the Government moving to an arrangement by which it took its royalties in cash so that it did not have to sell oil directly itself, provided that this change could be made at a time when it was least financially disadvantageous. Your Secretary of State suggested that an assessment should also be made of the scope for the OPEC countries to damage British interests if they came to believe that our failure to restrict North Sea oil production was causing a fall in the oil price.

Summing up the discussion, the Prime Minister said that there was agreement about the difficulties in restraining North Sea oil production. However, she would be grateful if your Secretary of State, in consultation with the Chancellor of the Exchequer, could consider methods and timing of a move to take North Sea royalties in cash rather than in oil. She would ask the Foreign and Commonwealth Secretary to have an assessment prepared of the likelihood and possible scope of OPEC retaliation against British interests on the lines proposed by the Secretary of State.

I am copying this letter to Rachel Lomax (HM Treasury), and to Len Appleyard (Foreign and Commonwealth Office) with the request that he should arrange for an assessment on the lines indicated in the latter part of the Prime Minister's summing up.

Yours ever,

Robin Butler

Michael Reidy, Esq.,
Department of Energy.

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copy no (1) of 4

13

Prime Minister

You might like to have a word with the Secretary of State for Energy and the Chancellor at your meeting tomorrow morning.

FERB 25.3.

PRIME MINISTER

On Friday afternoon, at his request, Shaikh Yamani flew in to Yorkshire to have a talk with me on the current oil situation.

He endeavoured to give the impression that he and others in OPEC had some doubts about our BNOC announcement, and he was very concerned as to how we were going to fix the oil price for the purposes of taxation.

I strongly pointed out to him that you and I had had the courtesy to discuss our ideas on BNOC with him; that he had been strongly in favour of such action; and that it was only after such consultation that we had made our final decision. Therefore I hoped he would have appreciated that, once again, we had done everything sensible and practical to help maintain stability.

On the question of fixing prices for taxation purposes I said there would be no difficulty in doing this, and that it would not be done by means of regular public pronouncements. Indeed, there had always been variations in the prices that had been agreed for these purposes.

He suggested that we should engineer some way of fixing taxation prices above current spot market prices - which would mean higher taxation for us, and more stability for the market. I explained there was no possibility of this.

His main purpose, however, was to argue strongly that it was essential when the market was weak that HMG should use its powers over royalty oil to reduce the supply to the market. Specifically, he suggested that we could inform North Sea

SECRET

licensees that we would defer taking our royalty oil until a later date. He argued that this would have no adverse affect upon the companies, but would reduce the volume of North Sea production for that particular period.

I pointed out that if we acted on his suggestion there would be nothing to prevent oil companies from maintaining production at current levels and selling to the market the oil we had decided to forgo. Obviously if this happened we would not succeed in reducing the supply of oil to the market. He expressed the view that ways could be found with the oil companies for the purpose to be achieved.

He informed me that he was deeply concerned because OPEC countries were becoming very tired of maintaining their restraint on supply. He said there was now a danger that the Soviet Union would return to their normal levels of supply, having gone through a period of production difficulties. (The previous day he had had detailed talks with the Soviet representatives which led him to this conclusion).

He therefore saw a danger that the whole international pricing system might break down, unless Norway and Britain agreed to show some restraint.

He pointed out that every year the supply from the North Sea had been greater than HMG had originally anticipated, and that this year's figures were reaching alarming heights. He argued that he could not see how the United Kingdom could be other than seriously damaged if there was a substantial collapse of the oil price. He felt that unless we made some contribution to stability there would be a breakdown in the OPEC system, probably led by Nigeria, which would be directly to our disadvantage.

He asked me to convey very strongly to you that, in a world where oil demand is static, and perhaps actually reducing, one

could not continue for much longer with a system whereby one section of the world restrained production, whilst other sections were actually increasing production to the maximimum. He felt that if HMG genuinely believed that oil stability was an important factor for both Britain and the western world at large we would, in the coming twelve months, have to make some positive contribution to that objective.

I explained to him the problems of putting production restraint on the North Sea and told him I would convey his views to my Government colleagues. He expressed his gratitude for that, but said that there would be nothing that would put a restraint on the North Sea more effectively than a total collapse of the world oil price.

My Department has also been alerted to this background by certain of the international oil companies who have had recent contacts with Yamani.

I attach a brief note of some of the possibilities which could be examined, if you thought it appropriate.

I am copying this minute to the Foreign Secretary and Chancellor of the Exchequer.

SECRETARY OF STATE FOR ENERGY

25 March 1985

SECRET

Last Summer Shell informally raised a number of ideas for cutting UKCS production at the margin, all of which would have cost HMG money, but not Shell, namely:

(a) HMG should leave its royalty oil in the ground for a number of months provided companies agreed to make an equivalent cutback in production. HMG would recover its oil as a result of higher production at some time in the future. This would be technically possible in Shell's main fields, but not in most other fields;

(b) HMG's Royalty oil should be produced, but then stored for a period;

(c) BNOC should not lift all its participation oil.

Shell was particularly keen on (a) above and almost certainly discussed the idea with Sheikh Yamani. Their partners, Esso, were strongly opposed.

In addition Shell, BP and Texaco advanced their annual maintenance programmes which temporarily reduced production. It should be possible to persuade them to do this again this year.

The National Archives

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Prime Minister (1)

A meeting has been arranged for Wednesday 6 March to discuss BNOC's withdrawal from contracts. PW is expected to circulate a note beforehand.

CONFIDENTIAL

AT 1/3

I will keep next Sunday lunch free

MR TURNBULL

1 March 1985

THE OIL MARKET

BNOC's respite has been brief. Two weeks ago a cargo of North Sea oil sold on the spot market for immediate delivery would have made a modest profit. Now BNOC would lose at least $0.5 per barrel, and oil for sale in the latter half of March would cost BNOC around $1.0 per barrel.

There is no cause for panic. There is not the pent-up pressure for a downward slide of oil prices such as we saw in December and January.

Free world demand is still stagnant at around 46 million B/D. The net demand for OPEC oil in 1985 is likely to be around 0.5 million B/D less than in 1984, but OPEC discipline on production quotas is being maintained and deviations from official OPEC prices have become fewer. The other stabilising factor is the exceptionally low level of oil stocks held by the oil companies. Shell and Esso independently estimate that commercial oil stocks are very close to the minimum required for the world oil supply system to function smoothly. The trend is striking:

Years	Commercial oil stocks in days of average consumption
1982	99 days
1983	91 days
end 1984	79 days
mid 1985	69 days (continuing)

BNOC remains a problem. A reduction of BNOC's official price, either by a fixed amount or by moving to a new basis and tracking the spot market, still carries a high risk of upsetting OPEC members, although of course BNOC's forced

spot sales are already putting downward pressure on prices. The Nigerians - so far continuing to sell their oil at what for them is a worryingly high price - would feel bound to respond. OPEC's fragile unity would be ruptured and bearish oil traders would begin another squeeze.

BNOC is exposed to financial risks on one-third of its total availability, ie 500,000 B/D. BNOC is now back in the red in having to sell this large volume through weak spot markets. The case for winding down BNOC's loss-making availability remains compelling. The security-of-supply argument has evaporated. Shell's latest 5-year forecast sees a continuing large surplus of supply potential.

Relying solely on BNOC's contractual arrangements, the loss-making availability could be reduced from the current 500,000 B/D to 210,000 B/D by 1.1.86. It should be possible to speed up the process by persuading the oil companies voluntarily to waive contractual arrangements already made - another challenge to Peter Walker's negotiating skills.

Peter Walker goes before the Energy Select Committee next Wednesday to defend his policy on BNOC. The parliamentary debate on the additional £25 million required for BNOC is likely to be around 15-20th March. Between those events would seem a good time to initiate the run-down of loss-making availability. We understand that nothing has been done so far.

JOHN WYBREW

6.58

1. TF
2. CF.

Prime Minister (2)

Treasury have updated the figures for the contribution of oil and gas. The 1984 figures are
(i) oil and gas as % of GDP "about 6%"
(ii) oil and gas as % of revenue "about 8½%"
(iii) oil (no gas exports) as % of exports of goods and services "about 16½%"

AT 26/2

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

26 February 1985

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew,

You asked about figures which the Prime Minister could use for North Sea oil and gas as a percentage of (i) GDP, (ii) Government revenue and (iii) exports (both goods and goods and services).

North Sea oil and gas as a percentage of GDP should be described as "about 6 per cent". I attach a note by Mr Walton of EB explaining this.

The figure of 8½ per cent for North Sea oil and gas as a percentage of Government revenue is correct for 1984/85, as forecast in the Autumn Statement.

The 21 per cent figure you mentioned relates only to oil, not oil and gas, as a proportion of total visible exports in 1984. The 1984 proportion of oil in exports of goods and services based on the Autumn Statement forecast is 16.5 per cent.

Yours sincerely,

Phil Wynn Owen.

P WYNN OWEN
Assistant Private Secretary

652/004

FROM: D WALTON
DATE: 15 FEBRUARY 1985

MR FOLGER

cc PPS/Chancellor
PS/FST
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Battishill
Mr Burgner
Mr Evans
Mr Allen
Mr Davies
Mr Culpin
Mr Griffiths
Mr Mowl
Mr Robson
Mr Hacche
Ms Leahy
Mr Page
Mr Pickering o.a.
Mr Pratt
Mr Vernon
Mr Webb
Miss Deyes

Mr T Jones - CSO
Mr N Coote - CSO

HE/17
Mr Turnbull

NORTH SEA OIL AND GAS AS A PROPORTION OF GDP

1. In response to a query from No 10, I have checked the figures for this in conjunction with DEn. The position in rounded terms is:

	percentage points of GDP		
	oil	gas	oil and gas
1983 (cf T3.7 of 1984 (Blue Book)	5½	½	6
1984 (estimate)	6	½	6½

2. The implicit all purpose formulation is thus that oil and gas account for "about 6 per cent" of GDP. This needs to be used from now on in place of the erroneous "about 5" formulation. The latter seems to have crept into briefing at the end of last month - not from EB - though perhaps we were remiss in not checking it!

David Walton.

D WALTON

26 FEB 1985

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CONFIDENTIAL

CCNO

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18/2

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London
SW1P 4QJ

15th February 1985

Dear Peter

BNOC PRICES AND FINANCES

Thank you for your letter of ~~13~~ February.

The letter of assurance given to Lord Croham does not of course commit us to reimbursing BNOC in March for any losses it may make during the month. There are special difficulties about using the Contingencies Fund across the year-end, as this would require. But subject to this timing point, I agree that if future pricing decisions meant that BNOC exhausted its reserves once again, we would no doubt have to find some means of providing it with funds so that it did not renege on its commitments. It is however premature to decide now how we would do this.

I very much hope that some way can be found to prevent further losses being made in view of the difficulties we face on the public expenditure front.

I understand that the last date that the £25 million late Spring Supplementary provision can be amended is Tuesday 20 February as a PQ would need to be answered by that date announcing the consequential increase in the cash limit of Class IV, Vote 5. If your officials can justify changes to mine by that date as a result of firmer figures on BNOC losses being available I would not object to a change being made.

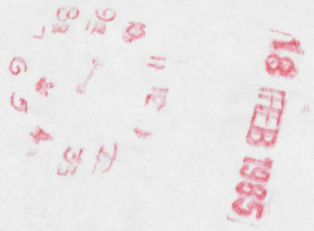
I am copying this letter to the Prime Minister.

Yours ever

PETER REES

CONFIDENTIAL

Energy: ~~Odd~~ Oil Prices Pt 2.



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M. Richards. Private Office 6.52

Mr. EGERTON.

OO WASHINGTON

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FM JEDDA 140745Z FEB 85
TO IMMEDIATE F C O
TELEGRAM NUMBER 083 OF 14TH FEBRUARY 1985
INFO IMMEDIATE WASHINGTON (STRICTLY PERSONAL FOR AMBASSADOR).

FOLLOWING STRICTLY PERSONAL FOR EGERTON.
F C O TELNO 65 TO JEDDA: OIL PRICES.

1. I AM ASKING MILNE, IN MUIR'S IMMINENT ABSENCE ON LEAVE, TO TAKE ACTION WITH THE SAUDI MINISTRY OF PETROLEUM AS SOON AS POSSIBLE, BUT IN PRACTICE THIS WILL NOT BE BEFORE 16 FEBRUARY.

2. MEANWHILE, I UNDERSTAND (MY PERSONAL LETTER OF 9 FEBRUARY TO YOU) THAT IT HAS NOT YET BEEN POSSIBLE FOR MR WALKER TO MEET SHAIKH YAMANI AS FORESHADOWED IN THE PRIME MINISTER'S MESSAGE WHICH I DELIVERED ON 13 JANUARY (MY TELNO 27). SINCE I UNDERSTAND FROM SIR JAMES BLYTH THAT KING FAHD IS LIKELY TO REPLY TO THE PRIME MINISTER'S MESSAGE FOLLOWING HIS CURRENT VISIT TO WASHINGTON, I WONDER WHETHER THERE WOULD NOT BE ADVANTAGE IN MR WALKER CONVEYING THE INFORMATION IN YOUR TUR BY PERSONAL MESSAGE TO SHAIKH YAMANI IN WASHINGTON? ALTERNATIVELY, YOU MIGHT WISH TO INSTRUCT SIR O WRIGHT TO TRY TO SPEAK TO YAMANI HIMSELF. EITHER ACTION WOULD AT LEAST BE SEEN BY KING FAHD AND YAMANI HIMSELF, AS AN EARNEST OF THE PRIME MINISTER'S STATED ANXIETY TO ''HAVE THE FULLEST EXCHANGES'' WITH THE SAUDIS ON OIL MATTERS SEMI COLON BUT WE NEED TO MOVE QUICKLY.

?

WRIGHT

NNNN

14 FEB 1985

CONFIDENTIAL

Q10

NYSM
AT
13/2

CCMO

01 211 6402

The Rt Hon Peter Rees QC MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

13 February 1985

BNOC PRICES AND FINANCES

Following our decisions last Friday, my officials have been discussing with yours the size of the provision needed in the late Spring Supplementaries. I understand that they have agreed that £25 million or thereabouts will be needed to restore BNOC's reserves to an appropriate level at the end of February providing these reserves are not affected by any provision to cover losses made on oil lifted in March but sold earlier. Such losses cannot, of course, be established until a decision is made on March prices.

Our next opportunity to obtain further provision to fund BNOC, should it be needed is, I understand, not until July/August when the Main 1985/86 Estimates and the Summer Supplementaries fall to be approved. It is not impossible that BNOC will continue to make losses beyond the end of February as a result of our future decisions and that these losses will exhaust its reserves. I understand that in such an event, moneys would have to be advanced out of the Contingencies Fund to avoid BNOC having to renege on its commitment.

On the understanding that you would agree that recourse should be had to the Contingencies Fund in the circumstances described above, I am content to seek provision of £25 million by way of a Late Spring Supplementary. I hope that it would be possible for minor adjustment to be made over the next week or two as BNOC's estimates of its January and February losses firm up.

It would, of course, be my intention to pay grant to the Corporation only in respect of losses certified by the auditors as arising from the exercise of the Corporation's powers to enter into and give effect to participation agreements.

I am copying this to the Prime Minister.

PETER WALKER

CONFIDENTIAL

13 FEB 1985

File Subject ECL!!
c. Master Set

10 DOWNING STREET

8 February 1985

From the Private Secretary

Dear Michael

BNOC AND OIL PRICES

The Prime Minister held a meeting today to discuss developments in the oil market. Present were the Foreign Secretary, the Chancellor of the Exchequer and the Secretary of State for Energy. The Prime Minister summarised the points which had emerged from the various discussions that had taken place during the course of the week.

First, it was clear that OPEC would react sharply to an announcement by BNOC that it was setting its January price at the average of realisations in the month, with the price for February and March being set at the previous official price. They would regard the lower price for January as providing a discount. Secondly, OPEC did not object to a reduction in BNOC's participation agreements. They appeared to recognise the argument that, by offering higher prices, BNOC was actually encouraging production. Thirdly, it was agreed that the Government should take its royalty oil in cash rather than in kind. Fourthly, OPEC were arguing that excessive liftings could damage reservoirs and that, in consequence, it would not be difficult to persuade the oil companies to reduce their North Sea production. Finally, OPEC had reported the view of the Mexican Government that it could sustain a $1 per barrel fall in the price but that a $3 fall would damage the financial stability of the country which in turn would damage the US banking system.

In discussion, it was agreed that care should be taken in interpreting a number of these arguments as they clearly reflected OPEC self-interest. Nevertheless, although OPEC's view of a lower BNOC price for January was irrational (since what was at issue was a reduction in the buying price and BNOC was already selling at lower prices) the likelihood of retaliatory action had to be taken seriously. It was not necessary for BNOC to commit itself immediately to a price for March. The opportunity to scale down BNOC participation agreements should be taken; this could be a step towards the eventual winding up of BNOC. The Petroleum Bill proposed for the next session could provide a legislative vehicle for this as well as for introducing a mechanism which would allow the transition from royalty in kind to royalty in cash to be effected without a cash flow loss to the Government.

Summing up the discussion, the Prime Minister said BNOC should set its prices for January and February at the previous level. She invited the Secretary of State for

SECRET

Energy to prepare a paper setting out proposals for BNOC's withdrawal from participation contracts; considering whether the Petroleum Bill should provide for the winding up of BNOC; and examining how a move to royalty in cash could be achieved without a cash flow cost. The group should meet again when the paper was ready.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and Rachel Lomax (HM Treasury). I would be grateful if it could be shown only to those who strictly need to know if its contents.

Yours sincerely

Andrew Turnbull

(Andrew Turnbull)

Michael Reidy Esq
Department of Energy

8 February 1985

PRIME MINISTER

There is no sense in taking special steps to defer producing our oil on the grounds that it will be worth more in the 1990s. The market will take care of this. If the price now slides, then people wil defer their production plans without Government intervention. If the price stays up, it is probably worth more produced now. Why forego tax revenue and a good return for the oil companies?

Playing at Sheiks is a dangerous game.

We cannot rig the market because:

1. There is no shortage in world reserves. At the end of 1982, BP reckon there were 34 years of reserves at then production levels - a 20 year peak.

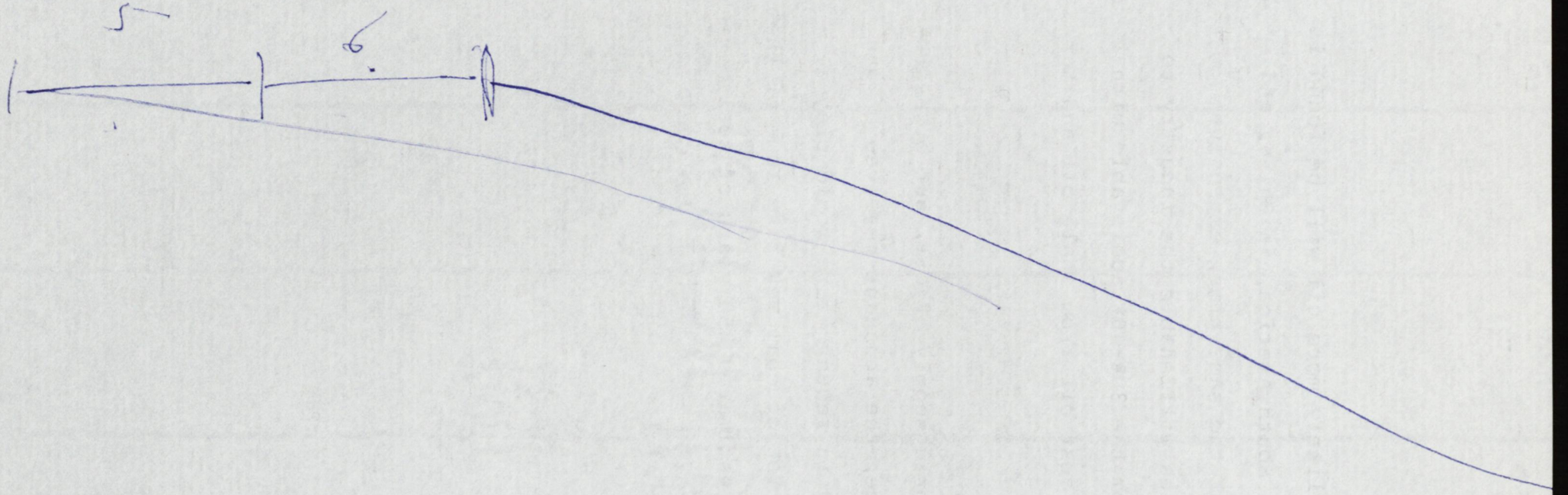
2. Future oil prices depend in large measure on what happens in the Middle East. New pipelines are being built and Iran, Iraq and Saudi Arabia are producing around 10m b/d less than at their peak.

3. Whilst further war in the Middle East could cut output more, there could just as easily be an increase in output and sales. The Middle East has 60% of world reserves.

4. As the price rises, it is likely more oil will be found in Central Africa, in Western South America, in China, and offshore in the Arctic. At the same time, expensive enhanced recovery techniques will enable the industry to push up oil recoveries from the 30%-40% achievable with current technology. High-cost oil from shale oil and tar sands will be developed.

5. What matters is not the world supply of oil, but of hydrocarbon. If oil gets scarce, the abundant reserves of gas which have been discovered in recent years would play a bigger rôle; and liquefaction of coal may take some of the strain. The world has an estimated 250 years of coal reserves.

JOHN REDWOOD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MR TURNBULL

8 February 1985

RUNNING DOWN BNOC'S AVAILS

1. BNOC's total oil availability is nearly 1.5 million b/d. It breaks down as follows:

Category	Proportion	
Royalty in kind	19%	BNOC not at financial risk.
Participation, but sold back at same price to companies like BP, Shell, Esso, Mobil	47%	BNOC not currently at risk. Future options need to be watched.
Participation oil onsold by BNOC	27%	BNOC at financial risk in weak markets.
Third-party contracts	7%	" " "

2. BNOC is exposed to financial risks on one-third of its availability ie 500,000 b/d. If BNOC relies solely on

contractual options this can be run down as follows:

Now	500,000 b/d
1/7/85	480,000 b/d
1/1/86	210,000 b/d
1/7/86	125,000 b/d
1/1/90	40,000 b/d

3. The converse of BNOC's financial exposure is commercial advantage to the oil companies. In current circumstances, the Government will need to persuade them voluntarily to waive options and third-party contracts already exercised. The principal targets are Britoil, Occidental, Enterprise Oil, Union Texas, Deminex, Amerada, Texas Eastern, Chevron, Marathon, Phillips, Conoco, Gulf and LASMO.

JOHN WYBREW

World Reserves of Oil and Gas — "Published Proved" — at End 1982

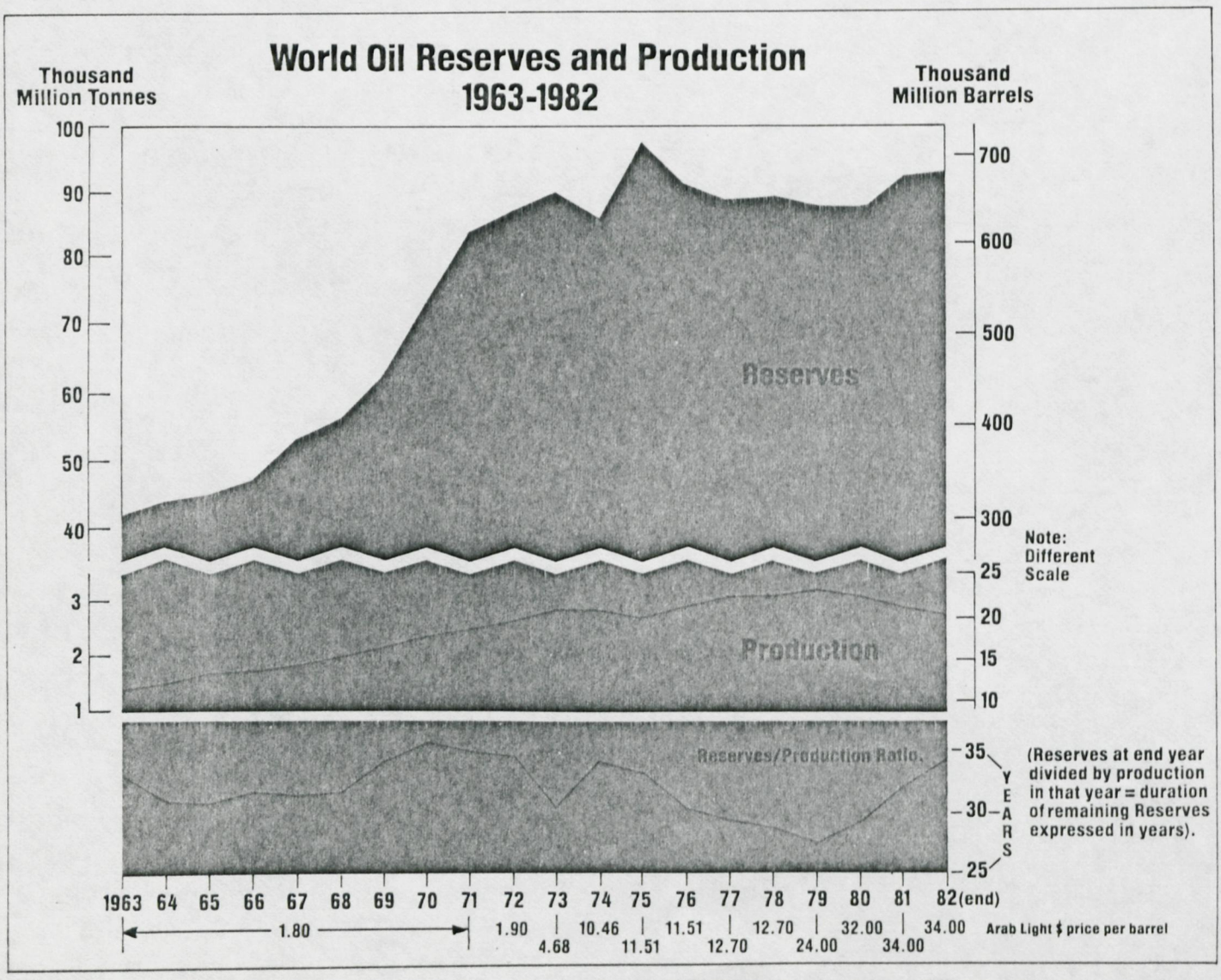
Country/Area	OIL			NATURAL GAS		
	Thousand Million Tonnes	Share of total volume	Thousand Million Barrels	Trillion* Cubic Feet	Share of total volume	Trillion* Cubic Metres
U.S.A.	4.7	5.5%	36.9	204.0	6.8%	5.8
Canada	0.9	1.0%	7.0	97.0	3.1%	2.7
Total North America	**5.6**	**6.5%**	**43.9**	**301.0**	**9.9%**	**8.5**
Latin America	11.0	11.6%	78.5	186.6	6.2%	5.3
Total Western Hemisphere	**16.6**	**18.1%**	**122.4**	**487.6**	**16.1%**	**13.8**
Western Europe	3.2	3.5%	23.5	158.8	5.2%	4.5
Middle East	50.2	54.4%	369.0	769.2	25.3%	21.8
Africa	7.7	8.5%	57.8	189.4	6.3%	5.4
U.S.S.R.	8.6	9.3%	63.0	1 240.0	40.9%	35.1
Eastern Europe	0.3	0.4%	2.4	12.5	0.5%	0.4
China	2.7	2.9%	19.5	29.8	0.9%	0.8
Other Eastern Hemisphere	2.7	2.9%	19.8	146.2	4.8%	4.1
Total Eastern Hemisphere	**75.4**	**81.9%**	**555.0**	**2 545.9**	**83.9%**	**72.1**
World (excl. U.S.S.R., E. Europe & China)	**80.4**	**87.4%**	**592.5**	**1 751.2**	**57.7%**	**49.6**
World	**92.0**	**100.0%**	**677.4**	**3 033.5**	**100.0%**	**85.9**

*Trillion: 10^{12}; one million million.

Source of data
Estimates published by the "Oil and Gas Journal" (Worldwide Oil Issue – 27th December, 1982), plus an estimate of natural gas liquids for the U.S.A.

Notes
1. Proved crude oil and natural gas reserves are generally taken to be the volume of oil and gas remaining in the ground which geological and engineering information indicate with reasonable certainty to be recoverable in the future from known reservoirs under existing economic and operating conditions. The data exclude shale oil and tar sands.
2. The recovery factor, i.e. the relationship between proved reserves and total oil or total gas in place varies according to local conditions and can vary in time with economic and technological changes.

Coal Reserves in the diagram on page 29 are copyright of and supplied by courtesy of the World Energy Conference (Survey of World Energy Resources 1980).



PRIME MINISTER

pa.

Briefing Meeting for Lunch with Shaikh Yamani

The purpose of this meeting is:-

(i) to consider BNOC's policy on prices and participation contracts

(ii) to brief you for the lunch with Shaikh Yamani.

On (i) you will wish to hear Peter Walker's assessment of the oil market after the OPEC agreement. John Wybrew has set out his thoughts at Flag A. The price of Brent crude is up to $28.45 only 20 cents below BNOC's existing purchase price. Should the price for January be left where it is which will represent an average loss for the month of $1·50 or should the price be maintained for February and March but with a lower price being set for January closer to the average which occurred during the month? At the last meeting, Mr. Walker told you that BNOC had managed to back out of a few participation contracts. Could he be more specific on what has so far been done and on how much further BNOC can go?

On (ii) you will need to agree how to broach whatever is agreed on BNOC with Shaikh Yamani. He is likely to urge production cuts on the UK though he is perfectly well aware of the Government's policy. The position is as set out in your reply to Patrick McNair-Wilson and the background note - Flag B. You will also need to agree any other points which you wish to raise with Yamani or he is likely to raise with you.

AT

Andrew Turnbull

5 February 1985

(A)

CONFIDENTIAL

PRIME MINISTER

5 February 1985

OIL PRICES

Many of the world's top oil traders will be in London later this week, not least to hear your speech at the Institute of Petroleum Dinner. They will have left their monitor screens secure in the belief that, if only briefly, the oil markets are relatively tranquil.

Since the OPEC meeting last week the downward slide of oil prices has been arrested. North Sea oil for immediate delivery is trading close to official BNOC prices. Around the cocktail circuit there will be much speculation as to whether this is a brief respite before a further slide - perhaps collapse - or the onset of a period of fragile stability. The American traders are the most bearish. The Europeans, including the analysts in BP and Shell, are more open-minded:

They concede that world oil demand is weak. US economic recovery seems to be slowing. Oil demand in Europe is still easing down. Overall demand in 1985 now looks like being only marginally higher than it was in 1984. On the other hand, OPEC production, at less than 16 million b/d, is probably below the current requirement for OPEC oil. Oil stocks are very low and should continue falling unless February and March are unseasonally mild. This Spring there could be an interesting coincidence between stocks reaching minimum levels

around 4 billion barrels, just at the time when OPEC is normally under greater strain.

The sceptics doubt OPEC's ability to operate within their self-imposed production ceiling of 16 million b/d, even with a competent auditor around to blow the whistle. Others believe that the new OPEC price differentials are less liable to induce cheating on price and, with it, cheating on volumes. All accept that Nigeria is a weak link since it is exposed to the strong market forces around the Atlantic Basin.

Amidst this speculation, there are a few points of widespread agreement - particularly on events that would trigger a further downward spiral of oil prices. One such is any reduction of BNOC's official price. This would be contrary to expectations and would be seen as putting irresistible pressure on the Nigerians to move down, and thereby destroy OPEC's fragile defences.

Action Items

Treasury will be supporting Energy in not wanting to risk a reduction of BNOC's official price for oil purchases made in February and March. However, they would like to retrieve BNOC's £20 million losses in January by paying producers the average price realised in the market - essentially the average spot price, $1.50 below official. Provided the presentation is well handled, this is a good ploy. The risk of Nigerian

retaliation should be confined to current and future BNOC pricing.

That ploy is probably a one-off, so Peter Walker's lack of progress in reducing BNOC's availability is a pressing concern. He may mention some success with BP, but we understand that this related to December; by January BNOC had taken the oil back into their trading portfolio.

JOHN WYBREW

2

Prime Minister

HOUSE OF COMMONS
LONDON SWIA OAA
31st January 1985.

MF

Dear Prime Minister,

Thank you very much for your letter of 30th January 1985., about my question to you, relating to the control of oil production in the North Sea.

I am most grateful to you for making the position so clear.

My only concern is that at this somewhat difficult time for sterling, which I believe will pass by mid year, we should use all the weapons available to us to protect the international value of our currency.

Whilst, I of course accept your view about the impact any production cut by us might have upon the world price of oil, I do nevertheless believe that provided we can demonstrate to Saudi Arabia, and the other big producers that we do not intend to throw caution to the wind, and engage in what they might regard as unfriendly acts, the more likely we are to see a return to stability in the oil market. This must be in our best interest.

Thank you again for so kindly writing.

Yours ever,

Patrick McNair-Wilson.

Patrick McNair-Wilson.

The Rt.Hon.Margaret Thatcher M.P.

cc D/N
SCSASR

(B)

10 DOWNING STREET

THE PRIME MINISTER

30 January 1985

Dear Patrick,

I am sorry that my answer to your Question yesterday afternoon, on limiting North Sea production, was not entirely correct. As you quite rightly said, the Government retains reserve powers to limit North Sea production. Under the terms of the licences, production must have the consent of the Secretary of State for Energy, and the levels of production for which consents have presently been granted could over time be varied.

But as I sought to say, the central issue is not what powers may technically be available, but the Government's overall policy towards the oil industry, which is of very great importance to us. Successive governments have aimed to create a climate of confidence to assure the very major investment decisions required for successful exploitations of th offshore petroleum resources, and to ensure the maximum benefit to the nation. Specific assurances have been given on the use of these particular powers. And you will probably recall that, in reply to the Select Committee on Energy's 3rd Report 1981-82, the Government agreed that such reserve powers should be retained, but would not be used lightly. The Government agreed with the Committee that the circumstances in which they might be used would relate to specific and overriding circumstances in the national interest or to a radical change in circumstances pertaining to the UKCS and its development.

Britain, with some 5 per cent of world oil production, is not in a position to exert any substantial measure of control or leverage over world oil prices. A move to cut UK production would impose very clear and tangible losses on the nation, while there is great uncertainty about any potential benefits. The use of these powers in present market circumstances is therefore not justified. As I remarked, the policy of the United States is really very similar. With four times our production their potential influence is much greater than ours if they saw a balance of advantage in seeking to hold back production.

Yours ever

Margaret

Patrick McNair-Wilson, Esq., M.P.

AT Briefing from Energy on oil production.

PRODUCTION CONTROLS

Background Note

1. Under the terms of model clauses incorporated in every licence, oil can be produced only with the consent of the Secretary of State for Energy. A production profile is negotiated as part of the development plan. The Department insists on a stringent interpretation of the requirements of "good oilfield practice" ie minimising risks of damage to the reservoir or of reducing ultimate economic recovery. Operators often seek production increases as development work improves knowledge of the reservoir characteristics, but this is not always agreed; sometimes the consent level is reduced. Consent levels are averages for the period, and there are no controls on daily or monthly production as such. But production has on occasion had to be reduced or shut in in order to remain within the consent.

2. About half of UK production comes from fields covered by short term consents, usually of 6 months' validity. These cannot be varied during their term without the licensees' agreement. Other fields have longer term approvals or consents. In most cases these can be varied after an initial period of immunity, but 6 months notice must be given, cuts are limited to 20% at most and the SOS must consider any representation made by the licensees on relevant technical or financial matters. A few SMALL 1 fields have long term consents which cannot be varied.

3. In addition to legal constraints, Ministerial assurances have been given on the possible incidence of production cuts. These limit cuts to 20% at most, even where that is not legal requirement. In some fields, even 20% might damage long term recovery and would not be attainable in practice. Also, all fields are assured of an initial immunity period, typically 4-5 years.

4. Overall it would be possible to impose cuts, at a minimum of 6 months notice, to the extent of something less than 350,000 b/d (13% of current production). This might be increased by something less than 50,000 b/d in stages over the following 12 months. The constraints are essentially legal, and are only marginally increased by the assurances.

irresponsible and irrational". If that is what he thought then, I hope that that is what he thinks now, and that he thinks that the action that has been taken to stop this is right and well judged in the circumstances.

Mr. Kinnock: I do think it irresponsible and irrational, but it is the right hon. Lady who believes in the market system and not us. Her response again today will impress nobody, either at home or abroad. It is the right hon. Lady who has surrendered policy-making entirely to the whims of the market. The result is chaos, a crisis of confidence and a huge rise in interest rate burdens on both business borrowers and home buyers. Is the right hon. Lady going to change her policies in the light of that experience or will she go on with the same mixture of panic and paralysis that has brought us to this mess?

The Prime Minister: I am not quite sure whether the right hon. Gentleman is objecting to what we have done or saying that we should have done nothing. In fact, the action that my right hon. Friend took was to maintain the financial strategy that has brought inflation lower for a longer period than any other Government have done previously and which, in spite of the effects of a coal strike —*[Interruption.]*—for 10 to 11 months last year has kept the current account in surplus.

Mr. Kinnock: The right hon. Lady's strategy is coming apart at the seams, and she knows very well that it is coming apart at the seams. What we want is a real strategy to give proper growth and recovery to our economy, and all we are getting from the Government, especially now, is dithering and, again this afternoon, dodging. That will only mean more on the dole and more in debt. We have not a crisis of confidence in the country but an absence of confidence in the Government. Are the Government willing to change their policies and will the Prime Minister really help by chucking out the Chancellor?

The Prime Minister: The action taken has been such as to impose financial discipline on all sections of the economy, including the Government. I remind the right hon. Gentleman that gross domestic product is at its highest ever level. I hope that he is pleased about that. Fixed investment across the economy is at its highest ever real level. Retail sales are at their highest ever real level; they have increased by 4 per cent. in volume. Profits increased by 20 per cent.—*[Interruption.]*—in the first three quarters of 1984. The Government's record on inflation is second to none. If the right hon. Gentleman listens to what is being said about unemployment he will understand that the most important thing in tackling unemployment is to keep down inflation.

Several Hon. Members *rose*——

Mr. Speaker: Order. I repeat what I said last week during Prime Minister's Questions. The Leader of the Opposition gets a fair hearing and it is only right that the Prime Minister should get an equally fair hearing.

Mr. Hordern: As interest rates have been increased to a level that must put at rest any fears that there may have been about inflation and as the markets are now offering the best opportunity ever seen for our exporters and businessmen to do business abroad, what reason have we to complain?

The Prime Minister: As my hon. Friend will be aware, markets are opening up because of the strength of the dollar and the weakness of sterling compared with the dollar. He will be aware also that it is vital to stay competitive on wage costs. The people who can benefit most from that are those who are best able to take advantage of the present exchange rate. My hon. Friend will know that our wage costs are rising and that the Opposition support every wage claim. At the same time, the wage costs of our competitors are either remaining stable of decreasing. If the Opposition want to improve the prospect of employment they must help to keep down unit wage costs.

Mr. Patrick McNair-Wilson: As, in part, sterling's problems stem from uncertainty over oil prices, and as overproduction at a time of depressed demand leads to a disorderly market, will my right hon. Friend confirm that the Government have reserve powers to limit production and depletion in the North sea? Will she consider using these to underpin the light crude oil price and so help to bring back stability to the oil market?

The Prime Minister: The policy that we pursue is really the same as that of the United States. We do not have powers to restrict production in the North sea but, we have powers to purchase 51 per cent. of that production at whatever is the market price. I think that we must stick to that.

Mr. Steel: When will the Prime Minister recognise that the rest of the world does not share her rosy view about her handling of the economy and that it is possible that the rest of the world is right and that she is wrong? Since she spoke on "Woman's Hour" and said that the pound was undervalued she has had to increase interest rates to their highest level for 150 years. Will she explain to the House why it is that the pound does not do what she tells it to do?

The Prime Minister: I note what the right hon. Gentleman says about interest rates. He will note that interest rates in real terms are not as high as they have been in the United States, and I am often urged to follow the course of the United States.

Q2. **Mr. Willie W. Hamilton** asked the Prime Minister if she will list her official engagements for 29 January.

The Prime Minister: I refer the hon. Gentleman to the reply that I gave some moments ago.

Mr. Hamilton: In view of the shambles in which the Prime Minister finds herself, does she not think that it is now appropriate for her to dispose of the Chancellor of the Exchequer, in the national interest? As she cannot find a satisfactory alternative, will she say whether the promised tax concessions will be implemented in the Budget? If they are, will that result in more new real jobs, in her terms?

The Prime Minister: I think that the hon. Gentleman must await the Budget. I remind him that the Government have raised the thresholds of personal taxation by 16 per cent. That means that income that is tax-free has been increased by 16 per cent. The previous Labour Government lowered thresholds.

Mr. Grylls: Does my right hon. Friend accept that, although the high interest rates that have had to be introduced are a worry and a difficulty for industry, business in Britain will, nevertheless, support the Government while they continue to keep inflation down? Indeed, business would probably send the Government a

Mr. Kirkwood: Will the Secretary of State confirm that it will be no part of the review that he announced earlier that he will allow the Americans to stockpile chemical weapons in British bases?

Mr. Heseltine: I have no proposals of that sort before me.

Ethiopia (RAF Aircraft)

12. **Mr. Wallace** asked the Secretary of State for Defence if he will extend the Ethiopian tour of duty of Royal Air Force transport planes for a further three months.

Mr. Stanley: Our offer to extend the airlift to the end of March and to review the position again nearer that time, has been accepted by the Ethiopian Government. I am glad to tell the House that the British RAF and Army detachment in Ethiopia has now airlifted some 6,000 tonnes of relief supplies, and has taken part in recent trials in the air dropping of supplies to more inaccessible parts of the famine area.

Mr. Wallace: I think that hon. Members on both sides of the House will pay tribute to the work done by the RAF. The public, having responded so well to the appeals that have been made, think that it is important, both for distribution purposes and psychologically, that the Government continue their commitment. Will the Minister give the House more reassurance about the future extent to which food can be taken to the Tigré and Eritrea regions of Ethiopia by the RAF?

Mr. Stanley: I am grateful to the hon. Gentleman for what he said about the contributions made by the armed services. Undoubtedly, they have been strikingly effective in the utilisation of the two Hercules that we have out there. We shall continue the dropping operation by conventional landing techniques, but, as I have said, we have just started exploring the possibility of air dropping. Whether we shall be able to do that will depend on whether we can put together arrangements for the landing of ground parties, which is obviously crucial when dropping by free fall.

Sir Hector Monro: Will my right hon. Friend go further and warmly congratulate the Hercules squadron —both the aircrew on their exceptional airmanship and the ground crew on their exceptional servicing record— thus keeping the squadron going on short runways and in difficult conditions, and thereby playing an important part in the relief of this difficult part of east Africa?

Mr. Stanley: I am most grateful to my hon. Friend. I can certainly bear witness, from my experience out there just before Christmas, of the difficult landing and take-off conditions that the RAF has successfully dealt with, not least in coping with the considerable problems represented by the bird strikes, which took out about 9ft of the leading edge of one of the wings of the Hercules just before Christmas. All concerned have done outstandingly well.

Mr. O'Neill: I congratulate the Government on their work, but will the Minister confirm that the cost of the work is being borne by the Ministry of Defence and will not be coming out of the overseas development budget?

Mr. Stanley: No, that is not quite correct. For the first three months of our contribution the costs were borne exclusively by the Ministry of Defence, on the defence budget. With the extension of the operation from the beginning of February we have agreed to share the costs equally between the Overseas Development Administration and the Ministry of Defence.

Royal Observer Corps

13. **Mr. John M. Taylor** asked the Secretary of State for Defence when he last reviewed the role and resources of the Royal Observer Corps; and if he will make a statement.

Mr. Lee: The role and resources of the Royal Observer Corps are kept under regular consideration in conjunction with the Home Office. The corps continues to provide an excellent service and there are no present plans for a review.

Mr. Taylor: While I thank my hon. Friend for his reply, may I ask him to say whether he is committed to sustaining the resources and morale of those who serve the Royal Observer Corps and will he from time to time say how the great majority of the British people appreciate its vigilance?

Mr. Lee: I am delighted to have this opportunity of paying tribute to the Royal Observer Corps. Its morale is excellent. It does a first-class job for us. There are 11,000 serving members at present and the corps costs less than £5 million a year. It is a first-class unit.

PRIME MINISTER

Engagements

Q1. **Mr. Dykes** asked the Prime Minister if she will list her official engagements for Tuesday 29 January.

The Prime Minister (Mrs. Margaret Thatcher): This morning I had meetings with ministerial colleagues and others. In addition to my duties in the House I shall be having further meetings later today.

Mr. Dykes: As there still is very great public anxiety on the subject, will my right hon. Friend undertake this afternoon to look at the subject again and reassure the House and the nation that the Government will look twice at the dangers of imposing any additional forms of taxation on pension funds or lump sum payments?

The Prime Minister: I recognise the concern about this subject. I refer my hon. Friend to the statement that was made in the House, in response to questions, by my right hon. Friend the Chancellor of the Exchequer. As my hon. Friend will be the first to appreciate, I cannot say anything more at the present time, but I do urge him to look at that statement by my right hon. Friend.

Mr. Kinnock: Three weeks ago the Government were against the idea of increasing interest rates to defend sterling, but they did increase them and it did not work. Two weeks ago the Government scorned the idea of intervening to defend sterling, but they did intervene and it did not work. Can the Prime Minister tell us what she is going to do now?

The Prime Minister: I recall the right hon. Gentleman saying on 15 January that he was absolutely against speculation against the pound and that he thought it was

HOUSE OF COMMONS

FIRST REPORT FROM THE ENERGY COMMITTEE

TOGETHER WITH AN APPENDIX
AND MINUTES OF PROCEEDINGS

Session 1982—83

NORTH SEA OIL DEPLETION POLICY: THE GOVERNMENT'S OBSERVATIONS ON THE COMMITTEE'S THIRD REPORT OF SESSION 1981–82

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MINUTES OF PROCEEDINGS RELATING TO THE CONSIDERATION OF THE REPORT

MONDAY 20TH DECEMBER 1982

Members present:

Mr Ian Lloyd, in the Chair

Mr Michael Ancram
Mr Ednyfed Hudson Davies
Mr Ted Leadbitter
Mr Robert McCrindle
Mr Michael Morris
Mr Arthur Palmer
Mr Tony Speller
Mr Edwin Wainwright

Draft Report, proposed by the Chairman (North Sea Oil Depletion Policy, The Government's Observations on the Committee's Third Report of Session 1981–82), brought up and read.

Ordered, That the proposed Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 13 read and agreed to.

A Paper was ordered to be appended to the Report.

Ordered, That this be the First Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 85 (Select Committees (Reports)) be applied to the Report.

APPENDIX

NORTH SEA OIL DEPLETION POLICY

Memorandum by the Secretary of State for Energy and the Chancellor of the Exchequer

Introduction

The Government welcomes the Committee's Report (published on 18 May 1982) as a thoughtful and constructive contribution to the consideration of the important question of the depletion of the nation's offshore oil reserves.

2. The Government cannot accept some of the Committee's arguments and conclusions, particularly the criticisms of the North Sea Fiscal Regime. But it agrees with the Committee's general conclusion that the emphasis at the present time should be to encourage exploration and development. The Government's objective is to maximise economic oil production over time. It has already announced that it does not intend to impose production cutbacks before 1985 at the earliest. It also considers that it would not be appropriate in the foreseeable future to delay development. There are, however, as the Committee recognise, many uncertainties on the oil scene and the Government welcomes the Commit-

tee's recommendation of the need for the Government to retain reserve powers which could be implemented should circumstances change. Meanwhile the need for good oil-field practice and the tight control of gas flaring will continue to be given high priority.

Government's Approach

3. Oil depletion policy must be consistent with the main thrust of the Government's wider economic policy objectives. As the Committee recognise, the Government has to consider very carefully both the macro- and the micro-economic effects of depletion decisions. These include the contributions current revenues make to the nation's prospects of general economic recovery; the possibility that, with rising oil prices, the revenues might ultimately be higher if production were delayed; and the effects that depletion controls might have on the thorough exploration and exploitation of the UK Continental Shelf.

4. Decisions on the rate of production would be much simpler if the future could be predicted with any certainty. As the Committee recognise, this is not possible. Uncertainties exist over world oil supply prospects, the ultimate size of the UK's recoverable reserves, the exact pattern of UK demand and supply over time, production costs, the future path of oil prices, the possible returns from alternative investments, and the particular relationships that may exist between the rate of oil production and other macro-economic factors. In particular, the future path of oil prices, which is crucial to any decision to intervene directly and sensibly to control UK oil production, is highly uncertain. The Government agrees with the Committee that clear economic advantages need to be demonstrated before a restrictive depletion policy can be justified. Such a clear economic advantage cannot be demonstrated, and in the Government's view the uncertainties are too great to justify Government action in the foreseeable future to delay UK oil production.

5. The Government attaches great importance to retaining the confidence of the UK oil industry. Depletion is one of the factors which determine the attractiveness of the UK as an operating environment for the oil companies. Other factors include licensing arrangements, the fiscal regime and political stability. The Government hopes that its recent announcement that there will not be production cuts before 1985 at the earliest, and this response to the Committee's Report, will be further encouragement to the oil industry to continue to invest in the North Sea.

6. The statement on oil depletion policy made by the then Secretary of State for Energy (The Rt Hon David Howell MP) on 23 July 1980 emphasised the major uncertainties about future levels of North Sea production and UK consumption which pointed to a flexible, case by case, approach to depletion decisions. The statement also stressed the need to ensure good oil-field practice at existing and new fields and stated the Government's intention to tighten control of gas flaring. Good oil-field practice and control of gas flaring remain essential to achieve optimum oil and gas recovery in the national interest.

7. The Report suggests (paragraph 19) that 'If the income over time from oil exploitation is maximised by the uninhibited actions of the oil companies it should also follow that Government revenues would also be maximised if the

tax system is designed to avoid distortions'. It goes on to recognise (paragraph 21) that the Government may have a different perception of the optimal depletion rate from the North Sea. This difference in perceptions may also arise at the field level. As the Committee note, the oil companies tend to use higher discount rates than the Government in valuing the streams of expenditure and income likely to arise from a new field and in assessing the attendant risks. The result is that companies will tend to put greater emphasis on high levels of production in the earlier years of field life, the Government relatively more emphasis on maximising the total amount of oil recovered over the lifetime of a field. All oil-field experience shows that too rapid a rate of depletion in the earlier years of a field's life can prejudice the total amount of oil ultimately recovered from a field. In these circumstances, it is not necessarily true that what is good for the oil companies is good for the nation. The Department of Energy therefore needs to pay particular attention to improving recovery ratios by ensuring that field development proposals are adequate to drain the likely oil accumulation(s) effectively (through the arrangement of production facilities, drilling programmes and well producing rates), and that pressure maintenance techniques are employed wherever possible at an early stage in field life.

8. The Government policy of reducing gas flaring where technically and economically feasible has succeeded in bringing it down from the peak rate of 21.5 million cubic metres a day (mcmd) in June 1979 to 12 mcmd in May 1982, while oil production has increased by 30% to its present level of around 2 million barrels a day. The purpose of reducing flaring for later recovery of the gas is to conserve a valuable resource in its own right, rather than as the Report implies (paragraph 76) to delay oil production (although that may in certain circumstances be an indirect consequence of flaring restrictions).

9. The Government agrees with the Committee that development delay is preferable to other available depletion controls. In economic terms, development delays are to be preferred to production cutbacks because costs, as well as production (and hence revenues) are delayed. Where a new field has discounted costs amounting to half its present value revenues, delay in developing the field begins to become economically attractive if oil prices rise in real terms at only half the discount rate; whereas production cuts, as the Committee recognise, only do so when the rate of increase in oil prices exceeds the discount rate.

10. Any development proposal now coming forward is unlikely to result in oil starting to flow until after the peak years of 1985–86 envisaged in the Department of Energy's central projections. In view of all the uncertainties and taking account also of the need to avoid any fluctuations in orders for new developments, in the interests of the offshore supplies industry (Report, paragraph 83), the Government agrees that there is no case in the foreseeable future for deferring new field developments. The Committee may be assured that there have not been, and will not be, any avoidable delays in consideration by the Department of Energy of new field development proposals.

11. The Government considers that what is required in the present circumstances is a pragmatic and flexible approach concentrating on:—

—the monitoring role favoured by the Committee;
—conserving gas for later recovery where technically and economically

feasible by continuing a tight flaring policy;
—encouraging further exploration (see paragraphs 15–20 below).

There is thus a wide measure of agreement between the Committee and the Government on the approach to oil depletion policy.

12. It is, however, the Government's intention to retain reserve powers of intervention, as the Committee recommend, against the possibility of some clear shift in the oil market or elsewhere which threatened to open up an important divergence between the national interest and the established pattern of depletion on the UKCS.

13. These powers will not be used lightly. The circumstances of their use would indeed relate (Report, paragraph 92) to 'specific and overriding requirements in the national interest or to a radical change in circumstances pertaining to the UKCS and its development'. The Committee gives an illustration of two such situations (Report, paragraph 46). To seek to move from illustration to specification of the conditions in which such controls would be activated (paragraph 92) is, however, unrealistic. The Government cannot responsibly constrain its ultimate freedom of manoeuvre. What it has done, and will continue to do, is to illustrate by its actions that there will be no wanton interventions to disrupt company expectations of their prospects on the UKCS. If circumstances should change such that it became necessary to consider seriously the use of reserve powers, the Government would certainly consider what assurances might be given in parallel.

14. For the reasons given above (paragraph 9), if reserve powers have to be used, development delay is to be preferred to other available options, as the Committee recognise. Royalty banking involves certain costs and potential risks for the Government, associated with the lack of incentive for companies to recover the banked oil when fields are in decline. It is not, therefore, an acceptable option.

The Longer Term—Licensing and Exploration Policy

15. The Government attaches importance, as does the Committee, to encouraging more exploration.

16. Much has already been achieved. 47 exploration wells were started in 1981—the highest number since 1977. Including appraisal drilling, 73 wells were started, a total higher than that of any of the three preceding years. Latest figures for the current year suggest that the level of exploration in 1982 will be higher still.

17. The Government has also increased the pace and scale of licensing through more regular and larger licensing rounds: the Seventh Round was as big as the two previous rounds together and attracted a high level of interest. The application rate for blocks in deep waters (up to 3000 feet), was high—22 out of 34 on offer—even though no special incentives (as proposed in paragraph 86(ii) of the Report) were offered. Altogether, 90 blocks were licensed—the highest number so far in any round since the Fourth—including 42 in areas commanding a £5 million premium. Some drilling under Seventh Round licences has already been undertaken, with encouraging results.

18. The Government proposes to license about 85 blocks in the Eighth Round. There will be a wide choice of blocks, in line with a suggestion made to the Committee by some of the companies. Areas in which there has as yet been no exploratory drilling will be opened up and further opportunities provided for exploration in the established gas province of the Southern Basin of the North Sea. The Round will for the greater part be based on the discretionary system but some blocks will be put up for auction. The terms of future licensing rounds will be kept under review.

19. The Government does not discount, as the Committee appears to do (Report, paragraph 86 (iii)), the importance of exploring territory licensed in the early rounds. These rounds involved large acreages. Until this territory has been drilled its prospectivity cannot be assessed. Some companies have tended to concentrate exploration activity in the particularly attractive territory offered in later rounds. The Government looks to the companies to increase their efforts in neglected territory.

20. The success of the Government's licensing and exploration policy will be kept under careful review as will the possible need for incentives to encourage exploration in frontier areas, such as the allocation of larger areas for individual licensing or longer periods for exploration (Report, paragraph 86(ii)).

Fiscal Regime and Depletion Policy

21. While tax must clearly be a factor to be taken into account in considering the implications of any depletion policy, the Government agrees with the Committee's view (paragraph 93 of the Report) that the fiscal regime is not (for reasons identified by the Committee) a suitable instrument for implementing such a policy, and the Government has not attempted to use it in this way. The Government's own analysis of the effects of the fiscal regime on North Sea development does however differ significantly from that made by the Committee.

The Level of Tax and Development

22. At paragraph 87 the Committee concludes from the evidence put to them that there is a substantial risk that development is being discouraged directly and indirectly by the form of the fiscal regime. The Government does not accept this conclusion. Before making its recent Budget proposals for oil taxation, the Government consulted very fully with the oil industry and considered carefully such evidence as oil companies provided on the effects of the tax regime either generally or on particular projects. In evaluating this evidence it is of course necessary to look critically at generalised assertions and so far as possible to seek more detailed evidence on the profitability of investments. The Government made its own thorough analysis of profitability both in relation to existing fields and also, on the best information available, in relation to likely future developments. The methodology used and some of the conclusions as at December 1981 were explained in the Treasury's Supplementary Memorandum (Q.2a, 2b and 3).

23. There is close and continuing consultation on this work between the Treasury, the Inland Revenue and the Department of Energy. The position is regularly updated in the light of revised forecasts of oil prices, costs and production profiles. Full use is made of the information supplied to the Department of

Energy on individual projects. Returns are examined against a variety of different assumptions. (For example, although the North Sea oil price fell by $4 just before the 1982 Budget, this was well within the price sensitivities tested.) A number of different indicators of profitability are examined, including internal post-tax real rates of return, net present values, and cash flows. Some guidance on the ranges of profitability which are likely to be regarded as acceptable by the industry can be found in evidence on existing projects, and in particular in evidence of forecast returns on these projects at the time it was decided to undertake them. On the basis of detailed analysis on these lines, and a critical appraisal of the industry's own representations, the Government believes that a wide range of potential developments in the UK Sector of the North Sea remains attractive. It considers that the fiscal regime is fully compatible with a satisfactory flow of new developments.

24. The Government has carefully examined the factors affecting the deferments mentioned by the Committee in paragraph 73 of the Report and other alleged decisions to postpone developments. It is not convinced that the level of tax has been the determining factor except in one or two cases where it appeared that the pre-1981 system was giving greatly excessive tax reliefs to incremental projects not justified in pre-tax terms. Apart from these, in cases where individual factors have been identified, other factors—in particular price uncertainties and specific technical problems—have been more significant than tax.

25. Obviously this is an area where difficult questions of judgment are involved, and the Government will bear the Committee's concern in mind. However this year's changes—apart from their important structural features (discussed below)—will reduce the burden on the companies by around £90 million in 1983–84 (allowing for the interest cost of accelerated payment). Important further modifications of the original Budget proposals were made at Committee Stage of the Finance Bill. These were designed to meet specific concerns of the industry in relation to less profitable fields. Continued discussions are being held with UKOOA on specific issues, in particular marginal fields and incremental investments in existing fields; the intention is that these should be based, so far as possible, on more detailed information than the industry has provided hitherto about post tax profitability and cash flow.

The Structure of the Tax Regime

26. As well as expressing concern about the level of tax, the Report also criticises its structure and calls for a thorough overhaul of the regime. (Some detailed comments on these criticisms are given in the Annex.) A number of important structural changes were introduced in the 1982 Budget and Finance Bill, which have now been further modified (subsequent to the Committee's Report) in a number of important respects by the changes announced by the Chancellor on 9 June. All these changes move in the direction sought by the Committee. From the beginning of 1983, the Supplementary Petroleum Duty which is based on gross revenues will lapse, and the arrangements for advance payment of PRT (APRT) will commence. While it is true that APRT will itself be calculated on the basis of gross revenues like SPD, it differs critically from SPD (which is a separate tax imposing its own permanent additional burden) in being an advance payment of PRT which is itself based on profits. It will normally

be fully set off against normal PRT liabilities once these arise. And, following the modifications announced on 9 June, liability to APRT will run for a maximum of five years for any single field and any APRT not set off within 5 years will be fully repaid then (rather than at the end of field life under the original proposals). The impact of APRT on less profitable fields has been modified to an important extent by these changes. Moreover liability to APRT (like SPD) arises only after an oil allowance of 1 million tonnes a year per field, which provides very substantial relief for smaller fields (whether these are more or less profitable).

27. It is true that APRT will still impose some tax liabilities before costs have been fully recovered. Indeed it is a main objective of APRT, like SPD before it, to ensure, following the increase in the real price of oil in the late 1970s, that the Exchequer should get some benefit from larger fields in their early years of production. Nevertheless, given that no PRT (apart from APRT) and no corporation tax are due until after costs have been fully recovered, the UK tax system still gives much more 'front end loaded' tax relief than most other tax systems. (For example, under the Norwegian system mentioned in the Appendix to the Committee's Report, relief for capital expenditure is spread over 10 years for both corporate tax and the Norwegian special tax.)

28. The Report refers (paragraph 74) to the continuing comparative complication of the North Sea fiscal regime, and also (paragraph 75) to the view of the Comptroller and Auditor General (in his Report on the Appropriation Accounts for 1980–81) that the effects of the present regime are difficult to calculate and are not readily predictable. The Government accepts that the regime remains a relatively complex one, although it believes that abolition of SPD as a separate fourth tier tax and the introduction of APRT (which has been built into the existing PRT structure and will now cease to have any relevance for any particular field within five years of first payment) achieves a modest degree of simplification. It is however inevitable in the Government's view that a regime which is designed to meet multiple objectives and to reflect the widely differing circumstances of oil development in the North Sea should be relatively complex. This is generally the case with oil tax regimes in other countries where the combination of some form of special tax with the normal corporate tax and royalties (which are a normal contractual obligation accepted by oil companies the world over) is commonly found. This complexity does, however, need to be seen in context. The taxpayers concerned are few in number, highly sophisticated and well supported by computer skills. There is no difficulty for them—or the Revenue—in calculating the effects of the regime, or the interactions of its different elements, on the basis of any given set of assumptions. There are of course major problems in predicting profitability of particular projects but this is not due to the complexity of the regime but to large uncertainties about the future of oil prices, production costs and production profiles. However the system might be simplified, these uncertainties would remain (as the Report recognised in paragraph 91).

29. The Report refers (paragraph 73) to the frequent changes in the system. It is true that it has not been possible to provide the degree of stability which had been originally hoped. But the economics of oil production changed so radically as a result of the increase in real oil prices in 1979/80 that it would have been unrealistic to expect that the level of tax or the form of its associated

main reliefs could remain unchanged. The main changes made by the present Government reflect this. There has also been a good deal of more technical legislation which has been necessary, often to meet problems put to Government by the industry. The latest changes have, of course, been made specifically in response to representations by the industry on the case for further structural changes.

A New Tax System?

30. The Report calls for a radical change in the tax system. It lists some desiderata for such a system in paragraphs 74 and 87: simplicity, stability, neutrality in its effect on incremental investments, progressivity to take account of large differences in unit costs and profitability, and a level of tax to ensure that high cost fields viable on a pre-tax basis remain so on a post-tax basis. The Government accepts these are in general terms all desirable features. There are however other objectives not referred to by the Committee—in particular the need to secure for the nation a fair proportion of the revenue from a national resource, and the need, where changes are made, to minimise disruptive transitional problems. And in the real world objectives will be found to conflict to some extent (e.g. some of the original reliefs designed to take account of differences in unit costs and profitability between fields were found to distort incentives for incremental investment, and a system which provides for rapid recovery of initial costs, and thus for a higher effective rate of tax later in field life, cannot be wholly neutral in its effect on the timing of incremental investments). What has to be achieved is a system which reconciles the various objectives to the maximum extent possible in practical terms. This can only be tested against precise proposals.

31. The structure proposed by the Government following this year's Finance Bill does in the Government's view represent a carefully considered attempt to meet so far as possible the various desiderata and objectives involved in a practical way. Apart from contractual royalties, it will be a system which, once any APRT liability has been set off or repaid, will be fully based on profits. It recognises differences in unit costs and profitability through the important PRT reliefs of oil allowance and safeguard. Detailed analysis has shown that after-tax rates of return on incremental investments after payback has been reached will, following the abolition of SPD, be very close to pretax rates of return. Small fields will pay little or no APRT or PRT (mainly due to the oil allowance) and post-tax returns are therefore not much more reduced compared with pre-tax returns than the returns of any other investment in the economy.

32. The Committee do not themselves spell out the form which they consider the tax structure would have to take to achieve the objectives more satisfactorily than the proposed system. Nor have they attempted to quantify the implications of their ideas in terms of cost (although they express the belief that the loss of revenue in the short term would be comparatively small). It is difficult for the Government to give a fully considered reaction to the Committee's ideas without knowing what sort of tax system they have in mind. The Government has devoted considerable effort and resources over the past few years to analysing a wide range of alternative tax systems, including for example schemes where tax is explicitly linked to profitability (on the lines recently proposed by the Institute of Fiscal Studies). It does not believe that these alternatives would meet the

various objectives involved more satisfactorily than the structure it now proposes. And it has noted that the industry itself is opposed to changes that would involve an unnecessary degree of structural upheaval, together with major uncertainties and significant transitional problems. The Committee themselves have stressed the objective of a greater degree of stability and the undesirability of frequent substantial changes. The Government is therefore opposed to the Committee's recommendation of another fundamental review.

33. The Government believes that the proposed oil tax system provides a reasonable compromise between conflicting objectives and a sound basis for the future. It will, of course, continue to discuss with the oil industry particular problem areas and has certainly not closed its mind to the possibility of detailed improvements if a case can be made out for these. But, as the Chancellor said in his Budget Speech, the Government hopes that the structure of the fiscal regime following this year's Finance Bill will provide a more secure and stable regime for the future, permitting development to go ahead uninhibited by major fiscal uncertainties.

The Fiscal Regime—Some Detailed Comments

Paragraph 71

The marginal rate of tax relief on an investment made after the safeguard has expired is 89.5% where the expenditure qualifies for royalty relief as conveying and treating costs under First to Fourth Round licences—the same as the marginal rate of tax on the resulting income. This results in the post-tax rate of return being very close to the pre-tax rate of return. Where royalty relief is not available and the marginal rate of relief is 85.6%, the difference is still not great. For expenditure at an earlier stage in field life the rate of relief is higher and can exceed 100% but the company normally has to wait for relief to be effective. This can result in post-tax returns being either somewhat higher or lower than pre-tax reliefs, depending on timing, but perfect neutrality is by and large not compatible with a system of front-end loaded reliefs, with tax low in the early years of a field life and high later on.

Paragraph 73

Companies paying PRT do not pay tax at a marginal rate of over 100% on North Sea profits. Because PRT is a tax on oil production profits and there is a ring fence around such profits for corporation tax, losses on activities outside the North Sea cannot be used to reduce North Sea taxes. If losses are being made at the margin outside the North Sea then the marginal rate of tax on a company's activities overall could in principle amount to over 100%. But the ring fence was introduced in 1975 precisely to stop losses outside the North Sea eroding North Sea tax take (see the Report of the PAC 1972/73) and we assume the Committee does not propose the ending of this principle which could put Government's share of North Sea revenues seriously at risk.

The paragraph suggests that when a field is paying tax at the full marginal rate of 90.28% the share of total liability taken by taxes on gross revenues is 36%. However even under the present system with SPD, it would be more accurate to say that the percentage is 22%; under the proposed regime it will

be between 0 and 14%. All existing fields, and many future ones, come under the first to fourth licensing rounds where conveying and treating costs are allowed against royalties. So to the extent that these costs are allowed royalties are not based on gross revenues; SPD is (although there is a substantial oil allowance not directly related to costs) but APRT is not in that once a field is paying at the full marginal rate APRT is immediately set off against normal PRT based on profits. Under the existing regime, therefore, SPD at 20% is in practice the only tax on gross revenues, equivalent to 22% of the marginal rate. Under the proposed regime no charge on gross revenues will be imposed on fields under the first to fourth rounds, and, where royalties at $12\frac{1}{2}$% are charged under the fifth and subsequent rounds (for which conveying and treating costs are not allowed), the charge on gross revenues will be equivalent to 14% only of the marginal rate. The Committee regard it as anomalous that tax take can increase late in field life; however, this is a corollary of the principle which they stress of giving the maximum front-end loading of relief to allow the cost of investment to be recovered quickly.

Paragraph 102

The opening sentence (on the flexibility of the Norwegian regime) seems difficult to reconcile with the statement in subparagraph (ii). The Government's own analysis of the UK and Norwegian tax regimes indicates that the UK system is much more flexible in giving relief to small fields (possible including complete exemption from PRT) than the Norwegian system. The UK average tax rate over the whole of field life ranges from 60–65% for small fields to percentages in the upper 80s for the very largest. This compares with 80–85% for nearly all fields under the Norwegian system. (The problems and objectives in development in the two countries do of course differ in significant ways, as the Committee recognise.)

July 1982

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Wednesday meeting today

Prime Minister (2)

An added complication is that Nigeria have deliberately set the price of its main crude at exactly the current BNOC price for Brent crude. Thus BNOC has no room for cutting prices without undercutting Nigeria. I will arrange another meeting on this before you lunch with Mr Walker on Wednesday.

MR TURNBULL 31 January 1985

AT 31/1

OIL PRICES IN THE AFTERMATH OF THE OPEC MEETING

The world's oil markets are the subject of much analysis. For all that, hard information is difficult to come by, even on basic elements such as production, demand and stocks. The latter is particularly obscure. For want of hard facts, sentiment and rumour play an important part in the behaviour of oil markets and the movement of prices. Hence, the importance of BNOC's next move on pricing - should we give OPEC a vote of confidence by leaving the official price unchanged, or not?

For weeks now oil company crude buyers have been holding back and buying no more than the bare minimum. With OPEC in disarray and spot oil prices falling, this made sense. Not surprisingly, the January liftings of oil from the OPEC producers have been unusually low; Shell would say around 15 million barrels per day (b/d); others, including Yamani, have quoted 14 million b/d. That means a shortfall against the world's demand in January of something like 1.5 - 2.5 million b/d. In other circumstances (such as those following the Iranian Revolution in 1979) this would have caused a panic. As it is, commercially-minded buyers have held back and dug ever deeper into their oil stocks.

The interesting thing is that as far as most experts can judge the world's operational oil stocks are now very low - even approaching the minimum. Some argue that this is not as crucial as it might appear, since there is a large cushion of compulsory emergency stock; some Governments are prepared to turn a blind eye to the use of such stock, thereby reducing the cost of oil imports.

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In any event, we now have a situation where:

- There are no uncommitted oil cargoes available for immediate delivery in Europe. (A reflection of this is the fact that the price of Brent crude for immediate delivery is nearly $28 per barrel - versus BNOC's official price of $28.65 per barrel).

- Significantly less cargoes than usual are on their way from the Middle East and Africa because of the recent stand-off by buyers.

- Yet in February and March there should be pent-up demand - perhaps 1 million b/d above the 16 million b/d limit which OPEC's new auditors will be policing.

- Action against tankers in the northern part of the Arabian Gulf is hotting up and the immediate signs are that little oil will be leaving Iran because the Iranians are not offering a large enough risk premium.

- In the United States, the most sensitive weathervane of the oil market, stocks have fallen sharply and product prices have perked up. This should underpin the price of the most widely-traded United States domestic crude, West Texas Intermediate, whose recent slide has played a large part in the bearish sentiment of the market.

- Yesterday's agreement by OPEC was as solid as anyone could realistically have expected. (At least the light crude producers in the Gulf do not need to cheat on price to sell their production entitlements).

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On the face of it, these positive indications should be persuading oil buyers to uncross their fingers, get into the market and buy. Against that, spring is round the corner and with it fears that OPEC will again be in difficulty.

My instinct is that the market is at a potential turning point. If BNOC holds its price, buyers will be encouraged to move in and buy more than the bare minimum. Spot prices will harden - probably above the official price. The recovery may not be sustainable, but while it lasts it will be helpful to sterling and interest rates.

JOHN WYBREW

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File

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DSG

cc MASTER

10 DOWNING STREET

From the Private Secretary

30 January 1985

Dear Michael

BNOC AND OIL PRICES

The Prime Minister held a meeting yesterday morning to discuss developments in the oil market. Present were the Secretary of State for Energy and the Chancellor of the Exchequer.

There was a brief discussion of the Secretary of State for Energy's meeting with the Nigerian Oil Minister. This concluded that even though it was difficult to do business with the Nigerians it was necessary to keep in touch with them. The Secretary of State for Energy said he had received a report from Shaikh Yamani at the conclusion of the first day of the OPEC meeting. Yamani was confident that the meeting would produce a good settlement on prices and that production would be cut to 14 mbd for the next quarter, a figure which would be monitored by the new audit group. The Secretary of State for Energy said Esso believed that if production were held at this level it would, in the short term at least, have a significant effect on prices as it would require a stock draw down of 5 mbd as opposed to the 3 nbd which most oil companies were expecting. There were, however, two adverse factors. In the short term, there was the prospect of a scaling down of oil burn by the UK which would reduce demand for heavy fuel oil by 500,000 mbd. In the longer term there were doubts about OPEC's ability to restrain production as on previous occasions it had responded to any easing in the immediate pressure by breaching agreed production levels.

The Secretary of State for Energy said Shaikh Yamani believed that there was a change of view about oil prices in the US Treasury, partly reflecting a change of officials. The US Treasury were no longer pressing so hard for a reduction in oil prices to $25 per barrel, but was now giving greater weight to the implications for the US banking system of a fall in oil prices.

The Chancellor of the Exchequer hoped the current uncertainty would be resolved quickly as this was particularly damaging for sterling. He hoped also that the settlement would include a reduction in the price of Arab

DG2ACM

Light as without this the package was unlikely to be credible. In discussion, it was agreed that BNOC could not settle its January prices until the outcome of the OPEC meeting was known. It would be necessary to inform Yamani before any announcement was made. This could be done by delaying an announcement until after 6 February when he would be in London on his way to Washington where King Fahd would be meeting President Reagan. This would give the Government an opportunity to explain its position fully. Yamani would, of course, press for production cutbacks by the UK though he was well aware of the Government's position on this issue.

The Secretary of State for Energy said BNOC had made a little progress in scaling down its participation contracts but it could proceed only cautiously as any major and overt move would incur OPEC hostility.

Summing up the discussion, the Prime Minister said no decision on BNOC's prices could be made at present. If possible, this should be delayed until after 6 February when Ministers would be able to explain the Government's position fully to Shaikh Yamani. Meanwhile BNOC should continue, as far as possible, to wind down its participation contracts. The eventual aim should be to take BNOC out of the pricing arena.

I am copying this letter to Rachel Lomax (HM Treasury) and Peter Ricketts (Foreign and Commonwealth Office). As with earlier correspondence on this subject, I should be grateful if it were shown only to those who strictly need to know of its contents.

Yours sincerely

Andrew Turnbull

Andrew Turnbull

Michael Reidy, Esq.,
Department of Energy.

fdo

UK's ENERGY RESOURCES STRONG ACROSS ALL FUELS

NOT JUST OIL

In 1982, the latest year for which figures are available, the UK was more than self sufficient in coal and we produced three quarters of our own gas consumption. By contrast Japan, France, Italy and Germany needed to import most of their gas requirements. Japan and Italy also needed to import the bulk of their coal requirements.

Percentage Self Sufficiency in Coal, Gas and Total Energy*

	Japan	Italy	France	Germany	USA	UK
Coal	19	8	52	99	107	106
Gas	8	48	26	34	92	78
Total Energy	18	20	40	48	88	119

* See annex for details.

2. Even if North Sea oil production stopped completely our coal and gas supplies and our nuclear and hydro generating capacity would be enough to meet more than 60% of our total energy requirements. Germany and France can produce less than half their requirements. Japan and Italy produce less than a fifth of their energy needs.

AJM/EcS
29/1/85

UK's Relative Fuel Self Sufficiency in 1983

Mtoe

		Coal	Oil	Gas	Nuclear	Hydro	Total
UK	Production	71	118	34	13	2	239
	Consumption	67	74	44	13	2	200
	Net imports etc	-4	-44	10	-	-	-39
	Self Sufficiency %	106	159	78	100	100	119
USA	Production	480	485	389	80	87	1521
	Consumption	448	695	420	80	87	1734
	Net Imports	-32	210	31	-	-	213
	Self Sufficiency %	107	70	92	100	100	88
Japan	Production	12	-	2	27	23	63
	Consumption	62	214	25	27	23	351
	Net Imports etc	50	214	23	-	-	288
	Self Sufficiency %	19	0	8	100	100	18
West Germany -							
	Production	84	4	14	16	5	123
	Consumption	85	109	41	16	5	256
	Net Imports	1	105	27	-	-	133
	Self Sufficiency %	99	4	34	100	100	48
France -							
	Production	14	2	6	36	18	77
	Consumption	27	88	23	36	18	192
	Net Imports	13	86	17	-	-	115
	Self Sufficiency %	52	3	26	100	100	40
Italy	Production	1	2	11	1	10	26
	Consumption	12	82	23	1	10	130
	Net Imports	11	80	12	-	-	104
	Self Sufficiency %	8	2	48	100	100	20

Source: IEA provisional energy balances for 1983 (April 1984)

Sterling and Oil Market Weakness

1. The prospect of collapsing oil prices is thought to affect sterling's relative parity in two ways. First, the currencies of the major net oil importers are boosted - this is a question of the Yen, Lira, Mark, Dollar rising rather than sterling falling. Second, the market believes that a falling oil price is likely to make it harder for the Government to keep to responsible money and fiscal policies. The apparent but misleading tendency for a falling £ to boost North Sea tax revenue in Sterling is part of this. It is misleading because the real effect of the falling £ is to boost inflation, boost public expenditure, while raising exports and reducing imports. It therefore reduces the scope and the need for a fiscal injection.

2. In any defence of sterling it would be counter productive to stress the UK's degree of energy self sufficiency; that would only reinforce the degree of gain that oil importers stand to gain from falling oil prices, boosting their currencies and as a counterpart weakening sterling. It would equally be counter productive to stress the extra oil tax revenue the Chancellor would receive from the falling £. That in a sense is what the market most fears

3. A better combination of arguments would be

a) Oil prices still stand at record levels in terms of the basket of manufactured goods that can be bought - this is largely because of the sharp rise in the Dollar.

b) UK non-oil exports (more than 85% of our total exports of goods and services) are rising sharply, up /11%/ in volume over latest year, and would be boosted by a fall in oil prices.

c) UK non energy industry and services (90% of the economy) would have its costs lowered by falling oil prices.

d) Oil countries might not benefit so much from oil price falls because the result coul well be for a period of energy supply an price turbulence. In such turbulenc insecurity, countries like the U relatively secure in their e would be better placed to we

e) Determination to continue to re to increase the scope for initiat the reward for enterprise.

f) Adjustment to exchange rates since 198 removed the "petrocurrency" gains made b 1980 and 1982. In real terms sterling is now highly competitive. Any further fall w not only be an unnecessary incentive, but wo needlessly damage our economic trading partner

2.63

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

28 January 1985

Tim Flesher Esq
10 Downing Street
LONDON SW1

Dear Tim,

I attach briefing as requested on the impact on Government revenues of a one dollar fall in the oil price. This has been approved by the Chancellor. He feels it is especially important to see the rise in the sterling oil price on page 2.

Yours sincerely,

Philip Wynn Owen.

P WYNN OWEN
Assistant Private Secretary

PRIME MINISTER

28 January 1985

BNOC'S OIL PRICING POLICY

Before Christmas, one of the big oil traders on the New York Mercantile Exchange gave its staff T-shirts bearing the slogan "25 in 85". When West Texas Intermediate, the most widely traded US crude oil, fell below $25 per barrel, the traders re-appeared with the T-shirts saying "25 in 85".

10 with the 2 crossed out

Oil industry analysts are not that bearish. With oil buyers holding back in anticipation of falling prices, current world oil production is close to, and quite possibly below, demand. This cannot be sustained for long, since world oil stocks are already very low, particularly in Europe. Longer term, the discouraging oil price outlook is putting a damper on investment in exploration and new development. Over time the structural imbalance between supply and demand will be corrected even if demand remains depressed.

In OPEC mythology it is the North Sea producers, particularly the British, who have let the side down by steadily increasing production, and by fostering a European spot market which has put downward pressure on oil prices. Today it is the animal commercial spirits of traders in North America that is probably the most potent factor in pushing prices down.

Unlike Governments and most consumers, traders relish instability and price movement. Once they sense that they have a commodity price on the run, be it oil or sterling, the instincts of the chase are powerfully reinforcing. The signs are that OPEC will fail to do enough at their Geneva meeting to shake off the psychological challenge of the "25 in 85" bears.

BNOC now has to set a price for oil purchased in January. Psychology is all important. For BNOC to cut its losses by switching to spot-market-related pricing will be a serious psychological blow to a despondent OPEC. Worse, it would be a stimulus to speculative traders relishing the downward slide of oil prices. (As we know, there are other traders in New York with "$1 = £1" on their T-shirts.)

Both Energy and Treasury want to avoid changing BNOC's official pricing policy at this critical juncture. They are right, especially in the light of today's news of a $2 or more price reduction by the Mexicans who are the fourth largest producer. At what point are the Saudi's provoked into radical measures like a sharp price drop? That would concentrate minds greatly, including the minds of those planning the next wave of production investment in the North Sea and other high-cost areas.

At your meeting on 16 January, it was agreed that BNOC should seek, as far as possible, to disengage from

participation contracts. Peter Walker should be pressed to pursue this with urgency. For BNOC to be a heavy forced seller on a weak spot market does nothing but depress prices.

JOHN WYBREW

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SENT 23 JAN 1985

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FM ALGIERS 240916Z JAN 85
TO FLASH FCO
TELNO 15 OF 24 JANUARY
INFO IMMEDIATE JEDDA, RIYADH
INFO PRIORITY KUWAIT, ABU DHABI, LAGOS, DOHA

YOUR TELNO 5 TO RIYADH : OPEC PRICING

1. I WAS ABLE TO HAVE A BRIEF WORD WITH ENERGY MINISTER AT OFFICIAL DINNER GIVEN FOR SAUDI CROWN PRINCE LAST NIGHT. I ASKED ABOUT RIYADH PRESS REPORT OF DOLLAR 2.50 PRICE CUT IN MARKER CRUDE.

2. NABI (WHO DID NOT ATTEND RIYADH MEETING HIMSELF) AVOIDED A DIRECT REPLY ON WHETHER THERE HAD BEEN DISCUSSION OF MARKER PRICE, BUT SAID WITH SOME BITTERNESS THAT A CUT OF THIS ORDER BY OPEC NOW LOOKED IRRELEVANT. WE COULD IN PRACTICE EXPECT PRICES TO FALL BY UP TO DOLLARS 5 TO DOLLARS 6 OVER COMING WEEKS. THERE WAS NO SOLIDARITY LEFT WITHIN OPEC: NORTH SEA PRICES COULD NO LONGER BE SUSTAINED AT TERM PRICE LEVELS AND A SPIRAL OF PRICE CUTTING WAS NOW IN PROSPECT.

3. ON DIFFERENTIALS, NABI SAID ALGERIA HAD PRESSED UNSUCCESSFULLY AT RIYADH MEETING FOR THESE TO BE NARROWED TO A PRICE MARGIN OF DOLLARS 1.50 AROUND DOLLARS 29 MARKER PRICE BETWEEN EXTRA LIGHT AND HEAVY GRADES. BUT SAUDIS HAD REFUSED AGREEMENT. DISCUSSION WOULD BE CARRIED FORWARD TO NEXT WEEK'S OPEC MEETING, BUT THE UPSHOT WAS LIKELY TO SERVE THE INTERESTS OF THE HEAVY PRODUCERS RATHER THAN THOSE IN NORTH AFRICA OR THE NORTH SEA. NABI DID NOT CONCEAL HIS CONCERN AT CONSEQUENCES OF A PRICE FALL ON THIS SCALE FOR ALGERIA'S HYDROCARBON REVENUES, GIVEN THE LINKAGE

SCALE FOR ALGERIA'S HYDROCARBON REVENUES, GIVEN THE LINKAGE BETWEEN HER CONTRACTED GAS EXPORT PRICES AND THAT OF A BASKET OF LIGHTER CRUDES.

4. I ASKED HOW HE SAW OPEC'S FUTURE GIVEN THESE DIVISIONS. NABI TOOK LINE THAT OPEC COULD NO LONGER PRESENT UNITED FRONT. AS RIYADH MEETING HAD SHOWN THERE WERE NOW TWO DISTINCT CAMPS. HE LAID BLAME ON SAUDIS. HE THREW OUT IDEA THAT IN THIS NEW SITUATION IT MADE SENSE FOR LIGHTER CRUDE PRODUCERS, BOTH WITHIN AND OUTSIDE OPEC TO COORDINATE THEIR POSITION MORE CLOSELY.

5. COMMENT. GIVEN CRUCIAL LINKAGE WITH GAS PRICES, ALGERIANS HAVE PERHAPS AS MUCH TO LOSE AS ANY OPEC MEMBER FROM A PRICE REDUCTION OF THIS ORDER COMPOUNDED BY CURRENT DIFFERENTIALS. NABI GAVE IMPRESSION THAT HE SEES SOME REDUCTION IN OPEC MARKER PRICE AS INEVITABLE, LEADING TO FURTHER UNDER CUTTING. IN THIS MOOD, ALGERIANS COULD ATTEMPT TO MUSTER A BREAKAWAY GROUP WITH LIGHTER CRUDE INTERESTS, AND WE COULD HEAR MORE ABOUT CONSULTATION WITH NORTH SEA PRODUCERS. IT SHOULD BE BORNE IN MIND HOWEVER THAT NABI MAY BE PLAYING HIS OWN GAME, SEEING HIS POLITICAL SURVIVAL AT STAKE AS THE ARCHITECT OF THE FORMULA LINKING ALGERIA'S GAS PRICES TO LIGHT CRUDES.

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TO IMMEDIATE F.C.O.
TELEGRAM NUMBER 54 OF 23RD JANUARY 1985.

INFO IMMEDIATE RIYADH.

YOUR TELNO 5 TO RIYADH AND TELECON MUIR/BLATHERWICK(EESD):
SAUDI OIL PRICE

1. WE HAVE SPOKEN TO THE JOURNALIST WHO WROTE THE ARTICLE IN TODAY'S 'ARAB NEWS' (ALSO CARRIED IN 'SHARQ AL AWSAT') ALLEGING AN AGREEMENT TO REDUCE THE DOLLARS 29 BENCHMARK BY DOLLARS 2.5, HE CLAIMED THAT HIS PIECE HAD BEEN BADLY EDITED : HIS ORIGINAL STORY, TO WHICH HE STICKS, SUGGESTED A 50-70 CENT CUT IN THE BENCHMARK.

2. HE HAS TOLD US THAT YAMANI TELEPHONED HIM TODAY TO SAY THAT ALL THAT HAD BEEN DISCUSSED AT THE MEETINGS IN RIYADH (MY TELNO 51) WERE DIFFERENTIALS NOT (NOT) A CUT IN THE BENCHMARK. THE 'ARAB NEWS' WILL CARRY THIS TOMORROW. THIS SUPPORTS THE ASSESSMENT IN RIYADH TELNO 107.

3. ESSD PLEASE ARRANGE FURTHER REPETITION.

WRIGHT

STANDARD (~~PALACE~~)

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SAMD
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SEAD
WED
MR JOHNSON
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TO IMMEDIATE FCO
TELNO 53 OF 23 JAN
INFO IMMEDIATE: RIYADH, JEDDA, KUWAIT, ABU DHABI, ALGIERS, DOHA.

YOUR TELNO 5 TO RIYADH: SAUDI OIL PRICES.

1. NNPC OFFICIAL WHO ATTENDED RIYADH MEETING HAS TOLD US THAT REUTERS REPORT IS MISLEADING. EXPERTS COMMITTEE AGREED TO RECOMMEND TO MINISTERS THAT PRICE OF SAUDI HEAVY (REPEAT HEAVY) CRUDES SHOULD BE DOLLARS 26.50 PB: AND THIS GRADE SHOULD EFFECTIVELY TAKE OVER THE ''MARKER'' ROLE.

2. PRICE OF SAUDI LIGHT WOULD BE ''VARIABLE'' IN THE RANGE OF DOLLARS 27.75 - 28.00 PB. PRICE OF BONNY LIGHT CRUDE WOULD BE RAISED TO DOLLARS 28.50 PB.

WYATT

STANDARD (~~PALACE~~)

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MR EGERTON

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FROM RIYADH 230931Z JAN 85

TO IMMEDIATE FCO

TELEGRAM NUMBER 10 OF 23 JANUARY

INFO IMMEDIATE JEDDA, LAGOS

INFO PRIORITY GULF POSTS, BAGHDAD, TEHRAN, JAKARTA, ALGIERS, QUITO, MEXICO CITY, CARACAS, WASHINGTON AND OSLO

JEDDA TELNO 51

MEETING OF OPEC PRICE DIFFERENTIALS COMMITTEE

1. THE MINISTRY OF PETROLEUM ARE BEING VERY CAUTIOUS IN THEIR COMMENT ON THE MEETINGS. HUSSEINI (DIRECTOR ECONOMICS) WHO WAS PRESENT TOLD ME THAT HE COULD SAY ONLY THAT THE POSITIONS ON DIFFERENTIALS HAD COME A BIT CLOSER. HE MAINTAINED THAT THE BENCH MARK PRICE HAD NOT (NOT) BEEN DISCUSSED AT THE MEETINGS. AS TO THE CURRENT SAUDI PRODUCTION LEVEL HUSSEINI SAID THAT IT WAS NOW QUOTE SOMEWHAT BELOW UNQUOTE THE DECEMBER LEVEL OF ABOUT 3.5 MBD. HE ADDED POINTEDLY THAT THIS WAS NO DOUBT QUOTE GOOD FOR SOME UNQUOTE.

2. THERE IS SPECULATION AMONG MAJOR OIL COMPANY REPRESENTATIVES HERE THAT YAMANI AGREED AT A PRIVATE MEETING WITH DAVID-WEST THAT SAUDI ARABIA WOULD NOT OBJECT TO A DROP OF ONE DOLLAR IN THE BENCHMARK PRICE IF NIGERIA AGREED ON DIFFERENTIALS AND UNDERTOOK TO KEEP TO ITS QUOTA. THIS WOULD NOT BE INCONSISTENT WITH HUSSEINI'S REMARKS.

3. WE HAVE CHECKED ON A REPORT BY A RIYADH CORRESPONDENT IN TODAY'S LOCAL ENGLISH LANGUAGE PRESS THAT THERE WAS AGREEMENT AT THE MEETING ON A DOLLARS 2.5 CUT IN BENCHMARK PRICE. THE MINISTRY OF PETROLEUM HAVE AS YET OFFERED NO OFFICIAL COMMENT BUT WE CONCLUDE THAT IT IS INACCURATE: THE ARTICLE CONTAINS SEVERAL OTHER OBVIOUS ERRORS.

4. THE OIL COMPANIES ALSO TELL US THAT PETROMIN'S LPG CUSTOMERS HAVE BEEN NOTIFIED THAT ONLY FORTY PERCENT OF CONTRACTED VOLUMES OF PROPANE AND BUTANE WILL BE AVAILBLE IN FEBRUARY: THIS SUGGESTS PREPARATIONS FOR A STILL LOWER LEVEL OF CRUDE PRODUCTION.

MUIR

STANDARD (~~PALACE~~)

ESSD
ERD
TRED
ECONOMIC ADVISERS
ECD'S
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MR TURNBULL

17 January 1985

NORTH SEA OIL PRICES

You may have seen the attached piece in today's Times, stating that Norway has reduced its official oil prices by at least $1.45 relative to the price set last October. My advice from Shell sources is that this is not the case.

The Norwegian Government has taken no initiative, nor does it want to in current circumstances. However, Statoil, in its capacity as the major Norwegian producer, is faced with the contractual need to advise the companies who have been lifting its oil through December and January what prices they will have to pay. For December liftings, it looks as if Statoil will try to establish a common price for all oil of the same grade. For January, they may well have to negotiate different prices for different customers, depending inter alia on when the oil was lifted. In any event, the cosmetics of this are likely to be no change of the official Norwegian prices, with the individual transactions at discounts - as is the case for about half the OPEC oil. The real prices could easily be $1.50 below official.

As regards your note on yesterday's Ministerial meeting, one of the key questions is, of course, the outlook for UK spot prices by the end of the month. One could take comfort from the proximity of Saudi Arabian spot prices to the official prices, but we should not be too sanguine.

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There are two principal market places in the oil world, the Atlantic Basin and the Pacific Basin. These days, Middle East oil tends to gravitate towards the latter. The forces of the market are felt most acutely around the Atlantic Basin, with intense speculative trading activity taking place in North West Europe - stimulated by the "spinning" of North Sea crudes - and in the US. Nigeria is critical to OPEC because it is in the middle of this highly competitive market and cannot afford to be out-priced by the market-responsive producers.

Although depressed oil product prices are now reacting sharply to the cold weather, oil product stocks in the US are still comfortable. Accordingly, whereas European spot crude prices have been moving up steadily, in the US the movement is still sluggish. The important market signals over the next week will be those from the other side of the Atlantic.

Incidentally, I understand from Freemantle that no directive has yet been given to officials in Energy's Oil Division to wind down BNOC's participation contracts.

JOHN WYBREW

THE TIMES, 17 JANUARY 1985

Norway reduces oil price by $1.45

By David Young, Energy Correspondent

Norway has set its official North Sea oil price for January on a scale between $27 and $27.50, a fall of at least $1.45 over the previous official price set in October.

The new price structure takes the price of Norwegian Brent crude close to its present spot market rate of $27.25 and comes as crude oil prices in the United States are being cut and stocks of petroleum products are rising.

The new Norwegian prices will be at the higher end of the scale for Ekofisk crudes with Brent and Statfjord crude slightly cheaper.

Britain has yet to set its official North Sea oil price through the British National Oil Corporation and is unlikely to do so until after this month's emergency meeting of the Organization of Petroleum Exporting Countries (Opec) due to start in Geneva on January 28.

Opec had been hoping to maintain its $29 market price with bad weather forcing industrialized nations to buy in new supplies as stocks run down.

However, this strategy appears to have failed and there is now considerable pressure building up within Opec for an official price cut.

However, in the United States the big oil companies have announced cuts in the prices they are prepared to pay per barrel fotr their refineries.

Exxon has cut the price it pays for West Texan intermediate crude by $1 to $28, bringing into line with Chevron and Texaco. Mobil has cut its buying price to $27.50 and Conoco to $26.70.

Prices on the US spot market have dropped to $25.90 and on the future market the price is now $25.91, a drop of mor than 20 cents in one week.

United States buyers are putting pressure on Mexico, a non-Opec member but one which follows Opec policies, to cut prices by $2 a barrel below the Opec marker price.

The downward price pressure i the United States is likely to continue in the wake of new statistics issued yesterday by the American Petroleum Institute which shows that last week petrol stocks rose by 0.2 million barrels to 241.6 million barrels while crude oil stocks rose by 5.9 million barrels to 341.7 million barrels.

Premier to raise £16m

Premier Consolidated Oilfields, which recently fought off a £100 million takeover bid from one of its fellow members in the consortium which owns Britain's largest onshore oilfield at Wytch Farm in Dorset, has announced that it is to raise £16.3 million from shareholders through an issue of 44,725,559 ordinary shares.

The money will be used to help finance further development at Wytch Farm over the next three years and new projects in Italy, Trinidad, the United States and the North Sea.

The company is also negotiating a production-shareholding contract in the Far East. Part of the proceeds of the issue may be used to buy into existing gas or oil production in the United States.

In the autumn Premier thwarted a takeover bid by Carless Capel and Leonard, which also has an interest in Wytch Farm and in onshore oilfields in Hampshire.

The new shares are being offered at 38p, a 7p discount on yesterday's price. Careless Capel and Leonard holds 14.98 per cent of the company

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SUBJECT
cc Master.

file JCR ARF 9

cc John Ledwood

10 DOWNING STREET

From the Private Secretary

16 January 1985

pa

BNOC AND OIL PRICES

The Prime Minister held a meeting today to discuss BNOC and oil prices. Present were the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, and your Secretary of State.

The Secretary of State for Energy reported on his meeting with Shaikh Yamani. The latter had been suspicious of the UK's intentions and had referred to a "Treasury" study which was supposed to show that a price of $25 per barrel would be in Britain's interest. (The Chancellor pointed out that this was probably a reference to a study by independent economists using the Treasury model.) Shaikh Yamani said the United States also favoured a price of $25 but, in his view, had not adequately considered how a controlled reduction could be achieved. Once the price began to fall, it could move substantially; it was not until the price fell below $20 that there would be any significant increase in demand. Shaikh Yamani claimed that a significantly lower oil price would damage the US banking system which had made substantially energy-related loans.

Shaikh Yamani thought the oil price would strengthen in the short term. Rather than the 15-16 mbd which was expected, OPEC's production in the next quarter would be around 14 mbd. This, combined with colder weather and the low level of stocks, would help the price up. Shaikh Yamani repeated his argument that the United Kingdom, while sharing an interest with Saudi Arabia in price stability, had made no sacrifice in the form of reduced production.

The Secretary of State for Energy said he explained to Shaikh Yamani why there could be no cuts in production proposed by HMG. Controls of gas flaring had only a limited impact. The Government had, however, incurred costs from allowing BNOC to maintain its selling prices. He had also explained why BNOC no longer had any significant influence on oil prices.

SECRET

Shaikh Yamani had argued that any attempt by BNOC to cut its prices would immediately be matched by the Nigerians who felt strongly that the UK was trying to undercut them and take their markets. In discussion it was agreed that talks with the Nigerians to explain the UK's position would be helpful and that the Secretary of State for Energy should arrange a meeting with the Nigerian Oil Minister as soon as possible. Shaikh Yamani had volunteered to help arrange this.

The discussion then turned to the price BNOC should set for January. The Secretary of State for Energy said BNOC would have to set a price in the last week of the month. If, as he expected, there was some strengthening of the market in the next two weeks, BNOC could set a price close to that ruling at the end of the month, and perhaps also extend this price through February. To relate BNOC's price to the average which had ruled during the month rather than the higher price ruling at the end of the month would, in his view, have a serious effect on the market.

The Chancellor said that, if BNOC maintained its existing price, the net cost to the PSBR for January could be £3½ million. Even in net terms, the losses were significant. Uncertainty over BNOC's pricing policy was an influence in the disturbed state of the foreign exchange markets and he hoped, therefore, that BNOC's pricing policy could be resolved quickly. Although OPEC were making a great effort to defend the price of $29 per barrel, they failed to acknowledge that, as a consequence of the increase in the dollar, the real price of oil had risen for all countries other than the United States.

Summing up the discussion, the Prime Minister said the group should meet again in the last week in January to consider the price BNOC should set for that month. The Secretary of State for Energy should contact the Nigerian Minister for Oil as soon as possible. Meanwhile, BNOC should seek, as far as possible, to disengage from participation contracts.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office and Rachel Lomax (HM Treasury). I would be grateful if it could be shown only to those who strictly need to know of its contents.

Yours sincerely

Andrew Turnbull

(ANDREW TURNBULL)

Michael Reidy, Esq.,
Department of Energy.

10 DOWNING STREET

Prime Minister

There are no new papers for this meeting. Mr Walker is meeting Yamani this evening and will come to the meeting tomorrow morning straight from the plane.

The Foreign Secretary and Chancellor will also be present.

Although the Chancellor is keen now to see immediate action, it remains important to pin Mr Walker down on what he thinks ought to be done. Does the Statoil move make it easier for BNOC to adopt market pricing for those contracts it can't get out of?

AT
15/1

FINANCIAL TIMES TUES JANUARY 15 1985

Norway set to move on oil prices

BY IAN HARGREAVES AND DOMINIC LAWSON

NORWAY IS on the point of agreeing spot market related prices for its December and January North Sea oil sales. Such a move could leave Britain alone in trying to delay pricing decisions until after the January 28 meeting planned by ministers of the Organisation of Petroleum Exporting Countries.

A Reuters report that Statoil, the Norwegian state oil company, had decided on spot-related prices had a big impact on sterling yesterday, but Statoil denied it had taken any decision.

Meanwhile, spot North Sea oil prices continued the rising trend of the past week, pushed mainly by cold weather. February deliveries of Brent, the North Sea reference crude, were traded at $27 a barrel, up about 20 cents on the day. In one transaction Arab Light, Opec's reference crude, was sold at $28.60 compared with its official selling rate of $29. The New York market opened firmer.

Statoil is expected to complete negotiations with its customers on its December and January prices in the next week, but certainly before the Opec meeting.

The company does not intend to reveal the outcome of the negotiations, but the average price of the company's crude is expected to be about $28 a barrel for December deals and about $27.25 a barrel for January deals. For technical reasons Norwegian prices are slightly higher than those for UK North Sea crudes.

The December price would represent a cut of about 75 cents a barrel on November levels when Statoil was still operating a monthly official price system.

Norway's decision not to fix official prices for December and January, but to rely on negotiations with individual oil companies based on spot market prices, mirrors a similar move by the British National Oil Corporation.

BNOC, however, having agreed spot-related prices with its customers for January deals, has been told by the Government to delay agreeing the price it will pay to suppliers.

This move is designed to avoid annoying Opec, which believes the switch to spot-related prices in the North Sea is a major factor undermining world oil prices. The Government also hopes that the combination of cold weather and the tighter controls of Opec production agreed over Christmas will help prices recover before BNOC makes its move.

Indications from major oil companies suggest that Opec production is now running at between 15.5m and 16m barrels a day compared with an intended production ceiling of 16m b/d.

Saudi production is thought to have been cut to 3.5m b/d, partly in response to sharply reduced January liftings by the members of the Aramco partnership.

● BNOC has realised an average price of about $27.35 a barrel for its sales of North Sea crude for delivery this month, according to Mr John Thompson, oil analyst at brokers Fielding Newson Smith.

Mr Thompson argues that BNOC is now mainly selling March crude, having disposed of most of its February North Sea production at an average price of about $27.00 a barrel.

● Shell is to follow Texaco by implementing price increases of up to 3½ per cent on the price it charges industrial and commercial customers for petroleum products. The company blamed the strength of the dollar, the currency in which oil products are traded.

● **Our foreign staff write:** Iran is offering a discount of $2 a barrel off official prices, which were realigned with Opec's structure last week, to compensate buyers for war risk insurance premiums and higher freight rates resulting from its conflict with Iraq.

There is a general understanding within Opec that it should be allowed to give such relief to customers.

The adjusted rate offered by the National Iranian Oil Company puts Iranian Light at $27.11 and Iranian Heavy at $25.55 against $26.30 and $26.40 respectively in December.

Initial indications were that Iran's important Japanese customers found the increased incentive for Iranian Heavy attractive but that for Iranian Light inadequate.

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TELEGRAM NUMBER 030 OF 14TH JANUARY 1985.

INFO PRIORITY RIYADH.

YOUR TELNO 11 : OIL : SAUDI POLICY

1. I HAVE NO DIRECT EVIDENCE OF WHAT WAS IN YAMANI'S MIND AT HIS PRESS CONFERENCE ON 29 DECEMBER WHEN HE SPOKE OF SAUDI ARABIA STARTING A PRICE WAR (FULL TEXT IN MEES OF 7 JANUARY). HIS REMARKS CONTRASTED WITH HIS EARLIER STATEMENT (MY TELNO 604) THAT THE SAUDIS DID NOT FAVOUR ANY KIND OF PRICE WAR. BUT I NOTE THAT HIS REMARKS WERE IN REPLY TO QUESTIONS ABOUT NORTH SEA PRODUCTION RESTRAINT. YAMANI STILL APPEARS UNABLE TO ACCEPT THAT HMG COULD NOT REDUCE UKCS PRODUCTION IF THEY REALLY WANTED TO. HE MAY FEEL THAT SUCH THREATS WILL IN THEMSELVES, PARTICULARLY AT A TIME WHEN THE POUND IS ALREADY WEAK, LEAD US TO RE-CONSIDER OUR PRODUCTION POLICY, AND TO DEFER ANY MOVE ON BNOC PRICING.

2. MY REPLIES TO THE SPECIFIC QUESTIONS IN YOUR TUR ARE:

A. I DOUBT WHETHER YAMANI HAD THE KING'S AUTHORITY FOR THESE REMARKS. IT IS NOT THE SAUDI WAY, OR THE KING'S STYLE, TO CONTEMPLATE A MOVE WITH SUCH UNPREDICTABLE CONSEQUENCES FOR SAUDI INCOME PLUS, AS YAMANI ACKNOWLEDGES, SERIOUS EFFECTS ON OTHER PRODUCERS AND THUS ON THE INTERNATIONAL FINANCIAL SITUATION. I DO NOT THINK THE SAUDIS WOULD LIGHTLY GIVE UP THE ROLE THEY HAVE BUILT UP FOR THEMSELVES AS GUARDIANS OF MARKET STABILITY. THE KING'S INCLINATION WILL BE TO SEEK A CONSENSUS WITH OTHER OPEC MEMBERS, POSSIBLY AT A SLIGHTLY LOWER PRICE (WHICH WOULD THEN BE DEFENDED) AND TO TRY TO PERSUADE OTHER PRODUCERS THAT THEIR INTEREST LIES IN ALIGNING THEIR PRICING AND PRODUCTION POLICY WITH OPEC'S. I DO NOT SEE YAMANI INITIATING A PRICE WAR WITHOUT THE KING'S PRIOR APPROVAL.

B. WERE THE SAUDIS NEVERTHELESS TO ACT, IT COULD BE THROUGH A CUT IN THE SAUDI OFFICIAL SELLING PRICE, POSSIBLY BACK DATED TO THE BEGINNING OF THE QUARTER, AND THROUGH THE RELEASE OF A GREATER QUANTITY OF SAUDI OIL ON THE SPOT MARKET.

C. THE SAUDIS WOULD NOT WANT TO ALIENATE OTHER MEMBERS OF OPEC: THE FACT THAT A PRICE WAR WOULD DO THIS IS A FURTHER RESTRAINT (COMPARE (A) ABOVE). THEY WOULD PROBABLY SEEK TO ARGUE THAT OTHERS HAD STARTED THE ROT BEFORE THEY. THEY A WOULD TRY TO CARRY THE OTHER GCC PRODUCERS AND IRAQ WITH THEM.

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/ D.

D. SAUDI ARABIA'S FOREIGN EXCHANGE RESERVES ARE ALREADY BEING BADLY DEPLETED AS A RESULT OF FALLING OIL INCOME. THE DRAW-DOWN IN THE PRESENT BUDGET YEAR (ENDING 21 MARCH) IS LIKELY TO BE AT LEAST US DOLLARS 20 BILLION. THIS WILL STILL LEAVE RESERVES AT AROUND US DOLLARS 90 BILLION, AND CAPABLE, FOR A SHORT WHILE AT LEAST, OF ACCOMMODATING MUCH HEAVIER DRAWINGS, TO SUPPORT A PRICE WAR. IN THEORY, THERE IS NO CERTAINTY THAT SAUDI ARABIA WOULDZT BE SUBSTANTIALLY WORSE OFF, IF A LARGE PRICE CUT RESULTED IN HIGHER OIL DEMAND (EXPORTS OF 3.8 MBD AT DOLLARS 15 PER BARREL WOULD GENERATE THE SAME REVENUE AS 2 MBD AT EXISTING PRICES). BUT PRACTICE, YAMANI HIMSELF CANNOT BE CONFIDENT THAT WORLD OIL DEMAND, WHATEVER THE SHORT TIME PRICE, WOULD BE SUFFICIENT TO ABSORB SIGNIFICANTLY HIGHER PRODUCTION LEVELS.

WRIGHT

STANDARD (~~PALACE~~)

ESSD
ERD
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UK AND WORLD OIL MARKET

FACTUAL BACKGROUND

WORLD SCENE

1. PRODUCTION

	4Q/1984 million barrels/day	NET EXPORTS
USSR	12.3	1.5
USA	8.8	-
Saudi Arabia	3.8	3.3
Mexico	2.9	1.5
UK	2.6	0.6
China	2.2	0.5
Iran	2.2	1.5
Other OPEC	10.7	7.6
Other non OPEC	10.2	-

2. DEMAND

	4Q/1984 million barrels/day
Communist Bloc	13.4
USA	15.8
W Europe (Excl. UK)	10.5
UK	2.0
Japan	4.7
Rest of the world	10.3

3. OPEC

Country	Quota	Estimated current production
Saudi Arabia	4.353	3.8
Iran	2.3	2.0
Iraq	1.2	1.2
Kuwait	0.9	1.0

Country	Quota	Estimated current production
UAE	0.95	1.0
Qatar	0.28	0.3
Venezuela	1.555	1.65
Nigeria	1.3	1.65
Libya	0.9	1.1
Indonesia	1.189	1.3
Algeria	0.663	0.6
Gabon	0.137	0.2
Ecuador	0.183	0.3
Total	16.0	16.1

4. OPEC DECEMBER MEETING

(1) Confirmed production programme of 16 mb/d. (Actual production, we believe, for December: 16.7 mb/d).

(2) Established new Audit Committee under Yamani which is charged with arranging for the independent audit of each country's production and prices.

(3) Agreed changes in price differentials: increasing price of heavy crudes by 50 ¢/barrel and of medium by 25 ¢/barrel; reducing price of very light crudes by 25 ¢/barrel (these will include UAE, African and, by extension, North Sea crudes), but maintaining price of OPEC marker, Arabia Light, at $29.

Nigeria, Algeria and Libya refused to accept (3) and UAE very restive. Further meeting on prices and differentials planned for late January.

5. PRICES. Current official and spot prices for some main crude grades are

($ per barrel)

	GSP	Spot
Saudi Heavy	26.50	26.50
Saudi Light	29.00	27.85
Nigeria Forcados	27.50	26.35
Brent Blend	28.65	26.55

All UKCS oil and probably some 60% of OPEC oil now moves at or near spot prices. The attached graph compares the movement of Brent spot prices and the value at the refinery gate of products made from Brent blend with the BNOC price.

BNOC

6. SUPPLIES. BNOC's sources of supply are:

	'000 b/d	
Royalty-in-kind	280	BNOC acts as HMG's agent. No financial risk to BNOC.
Participation saleback	540	BNOC resells to the licensee at the same price as it purchases. No financial risk to BNOC.
Other participation	480	BNOC at financial risk.
Other purchases (contracted)	100	BNOC at financial risk.
Total	1400	

7. Under the participation agreements, BNOC normally has to exercise an option to purchase the crude 6 months before it takes effect. It then normally last for a year but in some cases the option lasts longer. Consequently, BNOC could not escape from taking an

individual licensee's oil until between 12 and 18 months after it had decided not to exercise an option. Under most options it buys 51% of the licensees production. The table below shows how fast BNOC's participation avails and other purchases could be run down if licensees held BNOC to its contractual obligation:

	'000 b/d BNOC's supplies at financial risk
1/1/85	540
1/7/85	520
1/1/86	250
1/7/86	160

Thereafter gradually diminishing.

8. However, with the agreement of the licensee, BNOC could legally run down its availabilities very much faster. We believe that agreement could be reached with enough licensees for BNOC to shed between 50% and 75% (perhaps more) of its supplies at financial risk within 4-8 weeks.

9. PURCHASE PRICES. Under the Participation Agreements, BNOC is obliged to pay a "market price" to its suppliers which is frequently expressed as the term price. Recently the term price has been well above the true market price. Until the end of December BNOC paid its suppliers $28.65 per barrel for Brent Blend - the prices of other North Sea grades vary slightly around that price. Before Christmas, BNOC informed its suppliers that it would defer proposing a price for 1985 First Quarter sales until January and would then seek to backdate it. It has not yet made a proposal. Accordingly the price of BNOC's current supplies has not been fixed.

10. SALES AND SALE PRICES. All of BNOC's non-saleback oil is now sold at spot prices. About half of it is sold on a term basis (but at spot related prices) to a handful of customers, the largest of which are Esso, Shell and BP. The rest is sold directly on to the spot market. BNOC normally sells the oil available to it at least one month in advance. Thus it has sold all its January avails and is currently selling its February avails.

FINANCIAL EFFECTS

11. As BNOC has not yet agreed or even proposed, its term prices for January, it is impossible to say what, if any, its daily losses will be. If its retroactive price to its suppliers is based on realisations, its losses will be nil. If based on a formula, it may make a small profit depending on the exact terms it can negotiate. On the other hand, if it maintains its term price of $28.65, it will be losing £700,000 per day* in January, increasing to about £1 m per day** thereafter. However the Inland REvenue confirms that some 80% of this sum is clawed back through the tax system. The net monthly loss to the Exchequer is therefore some £3.4 m in January and £6 m per month thereafter.

12. Up to the end of December, BNOC's losses since July were some £33 m; its reserves at the end of the year were £2½ m before grant. It has now been paid an initial tranche of grant of £20 m. As mentioned, the scale of losses after 1 January depends on future decisions about the price BNOC pays suppliers. If the $28.65 term price is maintained, the £45 m already

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* 420,000 b/d at loss of $1.35 per barrel and
160,000 b/d at loss of $1.00 per barrel.

** 420,000 b/d at loss of $2.00 per barrel.
100,000 b/d at loss of $1.60 per barrel.
£ = $1.15

voted can cover BNOC's losses until the end of this month while maintaining BNOC's reserves above the £30 m with which it was originally endowed. But, unless a new provision for grant is made (or prices change) BNOC's reserves would reach nil during the first week of March. It would not, though, go into cash deficit until the beginning of April.

13. If BNOC were to move to a formula pricing system, its price would decline from $28.65 in December to $27.10 in January and (on the evidence so far this month) about $26.50 in February. For each drop of a dollar in the price of oil, the loss of tax revenue is £500 m in the first year and £640 m in subsequent years. However a decline in the price of oil is also likely to affect sterling parity. For each decline of 10 ¢ in the value of the pound, tax revenue increases by £1.25 bn per year. These figures really apply only for small changes. Major changes would have additional effects. For example, if oil prices declined below a certain level, UKCS taxation might have to be relaxed.

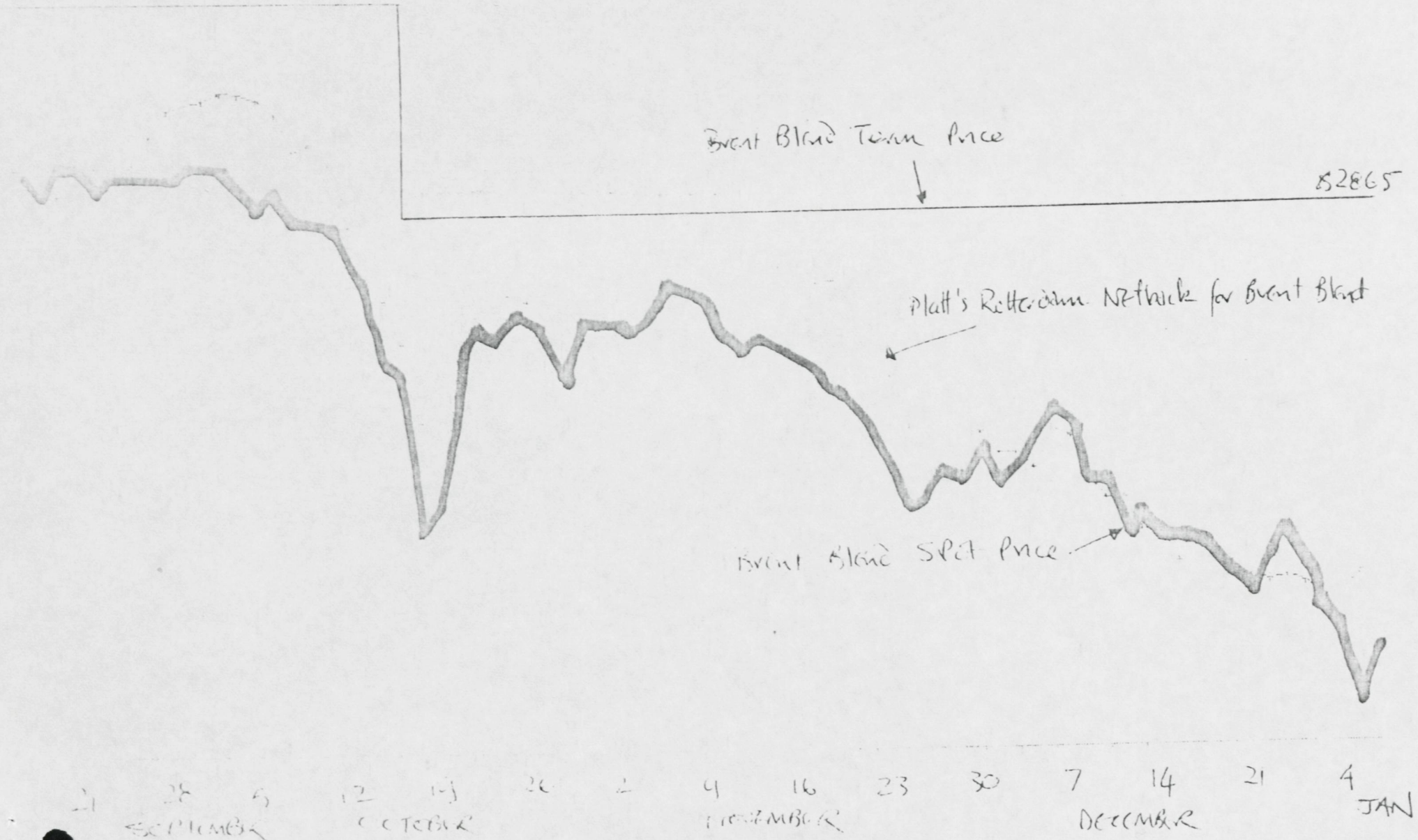
DEPLETION POSSIBILITIES

14. We have powers to control production. Taking account only of the legal constraints, we could theoretically make cuts in

67% of UKCS production from 1 July 1985
75% " " " 1 January 1986.

15. But certain of the Varley assurances still have force. Within those assurances we could reduce overall North Sea production by about 13% from 1 July 1985.

Brent Blend Spot Prices



15-16 m.b.d. . . .

14

Cut production?

2.1 m.b.d.

Prod^n. start falling.

½ day to see

B.N.O.C. - bad

psychological effect.

Nigeria

Nigerian Scene

Undercut.

↓

Minister

B.N.O.C

+ O.P.E.C.

27.30.

28.50.

27.50

28.50.

10 DOWNING STREET

Mr Turnbull.

Andrew. PETROLEUM BILL

This note is prompted by Peter Walker's recent letter to the Chancellor on the subject.

John Redwood and I felt that it may be useful for you to have our thoughts on the subject now so that you can use them if and when the need arises.

JMS.
11/1.

File

Spoke to Steve Robson. He agrees that issues raised in this minute need to be tackled but not read to raise in EC(A). The Crawley Group at Ireland Restaurant will

PTO

consider most of them

AT
28/1

MR TURNBULL

11 January 1985

PETROLEUM BILL

Energy are proposing a Petroleum Bill for the 1985/86 Session. The primary aim of the Bill is to improve the framework of legislation surrounding UK offshore oil and gas exploration and development. For example, with some fields nearing the end of their productive lives, it is recognised that the Government needs suitable powers to ensure that when the facilities are no longer operational they are properly dismantled and abandoned. Also, the Government needs to be sure that the licensees have made adequate financial provision to cover this obligation, the cost of which can run into hundreds of millions of pounds per field in the deeper waters of the northern North Sea.

Peter Walker contends that the Bill largely comprises a straightforward package of administrative improvements which do not raise significant policy issues and can therefore be cleared by correspondence between E(A) members. We believe that he is wrong. There are important policy issues associated with some of the proposed legislation. We are in danger of getting the cart before the horse - the administration before the policy.

Successive UK Governments have adopted the policy of developing our oil and gas resources by creating a commercial climate which stimulates the initiative and enterprise of the international oil industry, and other investors to commit their resources, skill and risk capital. The taxation system ensures that, if successful, the risk investors are well rewarded and that the balance of economic rent accrues to the Government. Understandably, the Government's efforts so far have been directed towards getting the "chemistry" right as regards exploration, appraisal, and the development of new fields. Now, we urgently need to turn our attention to the

first generation of mature North Sea fields approaching the point of economic abandonment. It is after all fields of this generation which are the largest and most productive. Even so, conventional oil field practice and technology would not recover more than 30-50% of the total volume of oil reserves in the ground.

Take a field producing exportable oil worth, say, $28 per barrel. As the field depletes, production declines and unit operating costs rise to the point where, coupled with royalty and tax, they account for all the $28 realisation and leave no reward for the resources and management effort committed. For the oil company accountants, the point of economic abandonment has been reached.

We don't need to shed tears for the oil companies; they will usually have made a good return on their previous risk investment. In any case, most of the oil companies have enticing new field development projects to be getting on with. But unless we devise a commercial framework which induces the oil companies to go on applying their ingenuity and resources until they have located and recovered the last barrel of oil or cubic foot of gas on which there is economic rent to be had, considerable benefits to the UK economy will be irrecoverably lost.

Unfortunately, things won't come right on the night. If we are to realise the maximum economic benefit from mature producing fields, the oil companies need to be aware now of what is in it for them. The lead times for extending field life and undertaking incremental development projects are long - entailing for example, detailed three-dimensional seismic surveys, more appraisal drilling, development planning, perhaps an experimental pilot test, construction, and meanwhile more rigorous maintenance of the existing facilities.

(Conclusion: Government should set itself the task of devising a commercial framework for maximising the economic benefit from mature producing fields in time for the 1986 Budget.)

The proposed Petroleum Bill would introduce a number of changes aimed at simplifying the calculation of royalty and removing anomalies and inconsistencies. As far as we can see, the Bill would not amend those provisions which make it financially advantageous for the Government to take royalty in kind rather than cash. The Government's need to dispose of the royalty oil is one of the factors used to defend BNOC against abolition.

(Conclusion: include provision in the Petroleum Bill to remove the handicap on royalty being taken in cash. Moreover, in view of the possibility that the Government may wish to abolish BNOC within the next year or two, we ought to prepare the requisite legislation and, at least initially, include it within the scope of the Bill.)

We do not feel that Peter Walker should duck the wider policy issues raised by his proposed Petroleum Bill. They should be considered in E(A).

JOHN WYBREW

8

10 DOWNING STREET

10 January, 1985

From the Private Secretary

BNOC and Oil Prices

The Prime Minister held a meeting today to discuss BNOC and oil prices. Present were your Secretary of State and the Chancellor of the Exchequer. Your Secretary of State said he had now arranged to meet Sheikh Yamani next Tuesday. He expected Yamani to argue that OPEC, and Saudi Arabia in particular, had borne the brunt of supporting the oil price. While benefiting from this, the UK had not only increased production but had regularly exceeded the Government's forecasts. OPEC argued that any major change in policy by BNOC could de-stabilize the market as it would be interpreted as a sign that HMG itself expected oil prices to fall. This could trigger a major slide in oil prices which would benefit neither Britain nor OPEC.

Your Secretary of State said that when he saw Yamani he would explain HMG's postion and take him through the options. He would emphasise that HMG was strongly opposed to cuts in production. These would represent a major reversal of policy and would damage the prospects for the development of the UKCS. (They would also bring the UK into conflict with the US.) In discussion, it was argued that the Saudi position was misconceived. BNOC was already selling most of its oil at spot prices. It was not its selling but its buying prices which were out of line; if anything, this was harming OPEC by encouraging higher production.

It was further argued that the best course for the Government was for BNOC to adopt a market-related formula for its buying prices and at the same time for it to seek, by negotiation, to reduce its involvement in participation agreements, thereby reducing its exposure to losses.

Summing up the discussion, the Prime Minister said the Secretary of State for Energy should set out for Sheikh Yamani the problems and options facing the Government. He should emphasise that there should be no question of cuts in production and that BNOC was no longer having a major influence on oil prices. A further meeting should be arranged for Wednesday of next week to discuss the outcome of that discussion.

CST.

I am copying this letter to David Peretz (Treasury) and Len Appleyard (Foreign and Commonwealth Office). I should be grateful if they could ensure that the contents of this letter are revealed only to those who strictly need to know.

ANDREW TURNBULL

Michael Reidy, Esq.,
Department of Energy

7

PRIME MINISTER

BNOC AND OIL PRICES

Mr. Walker has failed to produce any papers for this meeting, though I am told he will be bringing with him a factual paper setting out BNOC's legal and contractual position. I have set this out briefly in the internal note I prepared after your conversation with Mr. Walker on the phone. Nor has Mr. Walker produced a paper setting out the options for BNOC and their implications. These are:-

(i) To set a new lower term price, though this would leave BNOC vulnerable to a repetition of its present difficulties.

(ii) A move to a market-related formula.

(iii) For BNOC to back out as quickly as it can from its existing participation agreements, leaving it simply with the disposal of the Government's royalty oil. This option could be combined with leaving BNOC's official price at $28.65, though this would cease to have much meaning.

(iv) Abolish BNOC while appointing someone to handle royalty oil on an agency basis.

Option (iv) would require legislation and the contradiction of many of the arguments the Government used in 1982 when Britoil was hived off from BNOC. Option (iii) would require commercial negotiations with the companies. It would also raise the question of whether security of supply would be adequately provided for, though many would argue that BNOC does not materially enhance Britain's position.

It is clear Mr. Walker sees tomorrow as a preliminary discussion before he meets with Sheikh Yamani early next week. The Chancellor is worried that BNOC's loss-making position will drag on and on, and he will want to pin Mr. Walker down on what HMG's preferred course of action should be in order that Mr. Walker goes to the meeting with Yamani with some clear propositions in mind. At a minimum, the meeting should extract an undertaking from Mr. Walker to submit a paper on the options and their implications as soon as possible.

9 January 1985

EXTRACT FROM PROSPECTUS FOR 'ENTERPRISE OIL'

Depletion Control

The development of oil fields on the UKCS and the level of production therefrom require the approval or consent of HM Government and are subject to observance of "good oilfield practice". In December 1974 the then Government stated that no delays would be imposed on the development of UKCS oil fields discovered before the end of 1975 under licences held at the time of the statement and that no cutbacks would be made in production from these fields until 1982 at the earliest, or until four years after start of production, whichever was the later. (The Commercial Fields fall into this category). As regards oil fields discovered after 1976 under pre-1975 licences, no cutbacks in production would be made until 150 per cent of the capital investment in the field concerned had been recovered. Any production cutbacks would have full regard to the technical and commercial aspects of the fields in question which would generally limit cuts to 20 per cent at most. There would also be full consultation with the companies on any proposal to delay the development of post-1975 discoveries.

In July 1980, HM Government announced that its aim was to prolong high levels of oil production from the UKCS to the end of the century. As well as taking action to increase exploration it would be concerned to ensure good oilfield practice consistent with optimum oil and gas recovery both at existing fields and in regard to new field development proposals. It would also consider delaying the development of post-1975 discoveries and would continue to tighten control of gas flaring. Decisions would be taken on a case-by-case basis and the assurances given in December 1974 would continue to be honoured. HM Government further announced in June 1982 that it would not require production cutbacks at least in the period to the end of 1984.

In July 1982, HM Government published a Memorandum on North Sea oil depletion policy. This reaffirmed the decision on production cutbacks. It also stated that clear economic advantages would have to be demonstrated before a restrictive depletion policy could be justified; and that in HM Government's view there was no case in the foreseeable future for deferring new field developments. Reserve powers of intervention would, however, be maintained, but the circumstances of their use would relate to "specific and overriding requirements in the national interest, or to a radical change in circumstances pertaining to the UKCS and its development". If circumstances should change so that it became necessary to consider seriously the use of reserve powers, HM Government would consider what assurances might be given in parallel. If reserve powers had to be used, development delay would be preferred to other options such as production cutbacks. Further, the importance attached by HM Government to ensuring the maximum exploitation of oil and gas resources through good oilfield practice and the avoidance of wasteful gas flaring was reaffirmed, and it was made clear that HM Government's powers over oilfield operations would be used to ensure these ends.

DG2ABD

~~Enterprise Oil~~

Enterprise

North Sea Oil licenses.

file EZBACH

10 DOWNING STREET

8 January 1985

From the Private Secretary

SAUDI ARABIA: OIL PRICES

The Prime Minister proposes to send a message to King Fahd following her meeting with Prince Bandar yesterday, of which you have received a record.

I enclose a copy of the paragraph of the draft message dealing with King Fahd's suggestion of consultations between Britain and Saudi Arabia on oil prices. It follows closely the line taken by the Prime Minister with Prince Bandar. I should be grateful for any comments or proposals for amendment by 1300 tomorrow.

I am copying this letter to David Peretz in the Treasury.

(C.D. Powell)

Michael Reidy, Esq.,
Department of Energy.

CONFIDENTIAL

SUBJECT
cc. Master Set

10 DOWNING STREET

7 January 1985

From the Private Secretary

Dear Peter,

PRIME MINISTER'S MEETING WITH PRINCE BANDAR IBN SULTAN

The Prime Minister met Prince Bandar Ibn Sultan this evening. Mr. Blyth and Mr. Egerton were also present. The meeting lasted some 40 minutes. Much of it was concerned with the sale of Tornado to Saudi Arabia and I am recording this separately. This letter deals with the other matters which were touched upon.

Prince Bandar said that King Fahd had very much welcomed the Prime Minister's visit to Washington and discussion with President Reagan about the Middle East and had been grateful for the Prime Minister's message about it. The Americans had subsequently told the Saudi Arabians how effectively the Prime Minister had performed on the Middle East. King Fahd would himself be visiting Washington on 11 February to take matters forward.

The Prime Minister said that she thought her talks with President Reagan had gone well and that progress had been made both on the Strategic Defence Initiative (SDI) and on the Middle East. It was important to keep the President's mind focussed on the Middle East. She would be returning to Washington for further discussions with the President following King Fahd's visit in February. She would very much welcome it if King Fahd would be able to visit London on his way to or from Washington. Prince Bandar agreed that this would be useful. He would put the suggestion to King Fahd and let us know his response.

Prince Bandar said that King Fahd had also asked him to suggest consultation between Britain and Saudi Arabia on developments in the oil market. Britain's position was well understood by his Government. But the King believed that closer co-ordination could be of benefit for the oil market in the long term. Saudi Arabia wanted to avoid a situation in which the oil price fell uncontrollably. Once that started to happen there would be no means of re-asserting control. Contacts between Oil Ministers could analyse the

situation and possible developments, prepare the ground for emergency action if things got really bad (for instance if the oil price fell below $22 a barrel), and lead to a better understanding by the press and public opinion of the consequences of an unrestricted fall in prices.

The Prime Minister said that Britain wanted to stabilise oil prices. But we produced only 2.4 million barrels a day and no action by us would in itself achieve that. The main impetus for lower prices was coming from the United States. There was a risk that a further fall would put countries such as Mexico, Venezuela and Nigeria, many of whom were deeply in debt to the United States, into great difficulties. Britain was already losing a million pounds a day because of the current level of oil prices. The factors mentioned by Prince Bandar were much in our minds and we shared the Saudi desire for stability. BNOC would shortly be making proposals for new prices to run from the period from 1 January. She was sure that Mr. Walker would be ready to see Shaikh Yamani if he wished to come to London. Indeed, she might see him herself though a certain amount of discretion was necessary to avoid giving the appearance of crisis talks.

Prince Bandar said that such a meeting would be an opportunity for Britain and Saudi Arabia to consult before BNOC took its decision. The Prime Minister said that it had to be recognised that stability could not be found at present prices which simply were not holding. It was not possible to go against the market. Of course, each Government had to take its own decisions but she agreed that it was useful to hold consultations. She recognised how much Saudi Arabia had done to restrain its own production. Prince Bandar said that currently Saudi Arabia was producing only 3.8 million barrels a day although its entitlement was 4.5 million barrels. For a short period it had even gone as low as 1.8 million in order to help the market. Saudi Arabia was in the fortunate position of being able to draw on its financial reserves and investments. He wished to emphasise that his Government was not looking for binding agreements as a result of consultations, only a better understanding. Saudi Arabia's aim was to get a fixed price for a fixed period. This would help other countries plan their economic recovery. The Prime Minister said that the main aim should be to avoid sharp changes in oil prices. She would speak to Mr. Walker and ask him to contact Shaikh Yamani to arrange a further meeting. Prince Bandar said that it was important that this should be before BNOC took its decision. The Prime Minister said she must repeat that each Government must make its own decisions. Prince Bandar confirmed that he understood this. Saudi Arabia's interest lay in avoiding sudden price changes.

The Prime Minister would be grateful if Mr. Walker could contact Shaikh Yamani to arrange a meeting on the lines suggested. She intends to refer to this in a message to King Fahd.

I am copying this letter to Michael Reidy (Department of Energy) David Peretz (H.M. Treasury) and to Denis Brennan (Ministry of Defence).

yours sincerely,

Charles Powell

C.D. POWELL

Peter Ricketts, Esq.,
Foreign and Commonwealth Office.

SECRET

I. M Powell
> CF

6

NOTE FOR THE RECORD

Visit of Prince Bandar

The Prime Minister spoke to Mr. Walker on the phone this afternoon about the suggestion relayed by Prince Bandar that the Saudis would buy Tornados provided a number of conditions were met. One of these would be an undertaking by HMG to hold consultations with the Saudis and particularly before any major change in UK oil prices.

Mr. Walker said this had to be seen against a background of continuing Saudi criticism of the UK which was designed to put the blame on the UK for weakness in the oil market. The Saudis argued that they were bearing too much of the burden of production restraint and that the UK was benefiting from sustained oil prices while continuing to produce at its maximum. The Saudi's claimed that any cut by the UK in its oil price would bring the price structure tumbling down. Mr. Walker said he had met Sheikh Yamani before Christmas and had told him that he was greatly overestimating the ability of the UK to influence the oil market, one way or the other. Trading in the term market had declined in significance. The Saudi's criticism could more rightly be directed at the US whose production, at 8.7 mbd was far greater than that of the UK. US policy was to seek a reduction in the oil price to around $25.

The Prime Minister asked Mr. Walker how BNOC came to be buying oil which it could sell only at a loss. Was this by statute or by contract? Mr. Walker said this arose from the participation agreements which were a condition of production licences. Under these agreements BNOC had the right to buy up to 51% of a producer's output at the market price. He offered to provide a note with further details of how these arrangements put BNOC in a loss-making position.

SECRET

Mr. Walker said BNOC had sent a telex to its customers stating that it could not fix a price at present and would do so later in the month backdated to 1 January.

Mr. Walker said the Saudis were putting pressure on the UK to cut production though they knew that the Government had very limited powers to do this. He offered a note on the extent of production cutbacks which were possible.

The Prime Minister said she would tell Prince Bandar that there would be no objection to greater consultation with the Saudis and that Mr. Walker would be willing to meet Sheikh Yamani at any time. But there could be no question of agreeing to limit our production. HMG would have to take its own decisions on production and prices, as the Saudis would expect to do themselves. Mr. Walker said that BNOC was of no importance to the Department of Energy; it was not needed for the development of North Sea Oil. He believed, however, it could contribute to the Chancellor's aims. In the past it had helped to maintain prices and might do so at some time in the future though currently its influence was much diminished.

I spoke subsequently to Sidney Fremantle in the Department of Energy who gave me answers to the points on which Mr. Walker had been unable to respond to the Prime Minister's questions:

i) US production is currently 8.7 mbd compared with 3.5 mbd for Saudi Arabia and 2.4 mbd for the UK.

ii) BNOC's telex had stated simply that it was unable to set a price in current market conditions. It had given no suggestion as to whether a new term price would be

set or whether a new market related formula would be substituted.

iii) On production cutbacks, the Varley assurances had now largely expired and the assurances given by Conservative Secretaries of State for Energy had expired at the end of 1984. The Government had the power for most fields to require cuts in production of up to 20%. Ministers give production consents for specified levels of production for six month periods. For most fields the consents for the first half of 1985 have already been given at existing production levels. There are some smaller fields which cannot have cuts imposed on them for the next two or so years. Production from the Forties Field could be varied within six weeks. This would produce a cut of 100,000 bd, i.e. 20% of 420,000 bd. From 1 July production cuts could be imposed at 20% of 1.4 mbd. Thus although legal power exists it cannot be introduced at short notice. The main objection, however, is that production cutbacks would represent a major reversal of policy and would bring the UK into direct conflict with the US.

Attached is an extract from the Enterprise Oil prospectus which sets out the position on depletion of control.

iv) Under legislation introduced by the Labour Government BNOC was given the right to purchase 51% of output at market prices. This was also made a condition of subsequent licensing rounds. The participation agreements are commercial contracts. In a typical case, BNOC gives six months notice of its wish to exercise its

participation option which normally lasts for one year. In most cases notice is given in June of each year. Thus BNOC is committed for the whole of 1985 under the announcements made in June 1984 and in June 1985 it will announce whether to exercise its options for 1986. BNOC is currently committed to around 620,000 bd.

Mr. Fremantle thought that it would be possible for BNOC to bring some of the participation options to an end by mutual agreement at relatively short notice. He suggested that perhaps 50% of the agreements could be wound up within six weeks.

AT

7 January 1985

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PRIME MINISTER

7 January 1985

BNOC

UK oil production licences give BNOC the right to buy 51 per cent of the licensee's oil availability at the official price. The availability is less than total production, because it has been advantageous for the Government to exercise its right to take 12.5 per cent of the oil as royalty in kind. (BNOC acts as the Government's agent in selling this oil - in 1985 about 290,000 barrels per day.)

The participation agreements negotiated between BNOC and the licensees under the Labour Government do not all follow the same model. The big companies like Shell, Esso and - to some extent, we believe - BP, were able to negotiate a buy-back arrangement whereby they effectively retain their oil. Thus, in 1985, BNOC's foreseen oil availability would be:

- Royalty oil handled on behalf of HMG	290,000 b/d
- Participation oil purchased at official price	430,000 b/d
- Purchases from minor producers (without trading organisations) at official price	50,000 b/d
	770,000 b/d

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The principle behind the participation agreements was that BNOC would pay the producers a fair market price. Of late, however, BNOC has got itself marooned between the strategic pressures to support OPEC's official oil price structure and the market pressures reflected in the spot market. Thus, BNOC is having to pay the producers the official price of $28.65 per barrel, whereas virtually all the oil now has to be sold at spot prices (currently $26.25 per barrel). In consequence, BNOC is currently losing £1 million a day,, although £800,000 is recouped in high[er] taxes from the producers.

Much as we might wish it otherwise with oil markets nervous and looking for signals, BNOC cannot escape the spotlight. The UK is, after all, currently the world's fifth largest oil producer:

- USSR .. .. 12m.b/d (of which 1.5-2.0 million b/d exported)

- US .. .. 8.7m. b/d

- Saudi Arabia .. .. .. 3.5m. b/d

- Mexico .. .. 3.0m. b/d

- UK 2.7m.b/d

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So far, reactions to the December OPEC meetings have been adverse. Oil traders have given OPEC the thumbs down, maintaining that not enough has been done to contain the downward pressure on oil prices. Everyone is nervous and unwilling to buy oil for fear that prices will fall, perhaps sharply. Around the Arabian Gulf, there is a stand-off, with total OPEC production currently understood to be down to an exceptionally low 15m. b/d.

The gloomy scenario says that a downward price move by the UK, whether a discretionary adjustment or a decision to track the spot market, would:

- force Nigeria (and probably Algeria and Libya) to follow suit;

- make Yamani decide that he is at the end of his tether in trying to manage the market via cohesive OPEC discipline, and conclude that the only option is shock treatment - a severe downward price move.

We are working with DEn. officials on an analysis of the options and the associated risks. There are three measures which can be taken, probably in the order set out below:

1. Avoid a vote of no confidence in OPEC - and, above all, Yamani - by maintaining BNOC's official price at $28.65 per barrel for the time being, but reduce BNOC's losses

E.R.

CONFIDENTIAL

by winding down the participation contracts (speeded up with the voluntary support of the oil companies.)

2. Move to formula pricing, whereby BNOC tracks the spot market (preferably starting on a rising spot market and not, as now, when BNOC is the last check against a downward price spiral).

3. Abolish BNOC.

The effect of the current cold snap on a world oil supply system, with stocks approaching minimum levels, is the wild card.

JOHN WYBREW

CONFIDENTIAL

File

(1)

PRIME MINISTER

BNOC

Next Tuesday's money figures are close to what was indicated by the first guess. The Treasury hope they will be seen by the markets as good enough to improve market sentiment at least for a while. They believe, therefore, that there will be a window which should be taken advantage of to push through difficult decisions on BNOC.

When this issue was put to you before Christmas, you said you did not wish to see any action before the OPEC meeting on 19 December but that action should be taken as soon as possible thereafter - if possible, by 1 January. In the event, OPEC failed to reach agreement and meet again on 18 January. Meanwhile, the oil market has weakened further, at least when measured in dollar terms, though this may reflect the recent appreciation of the dollar. BNOC has written to its customers indicating that it will set prices for the quarter from 1 January respectively, thereby keeping its options open.

retrospectively?

The Treasury want to put an end to uncertainty by an early announcement that BNOC will adopt a formula relating its prices to market prices. They doubt whether the next OPEC meeting will be conclusive; even if there is an agreement, there will be doubts about whether it can be implemented. Mr. Walker attaches significance to the threats being issued by Sheikh Yamani and is nervous about action by BNOC ahead of the OPEC meeting. He will therefore be playing for time.

Agreed MS

Probably the only way forward is for you to have a meeting for the two of them in the second half of next week.

You may like to discuss this with the Chancellor at Chequers on Sunday evening.

AT

ANDREW TURNBULL

4 January 1985

CONFIDENTIAL

SCNO.

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

NBPM

OR
21/12

Andrew Turnbull Esq
Private Secretary to
The Prime Minister
10 Downing Street
LONDON SW1

21 December 1984

Dear Andrew

BNOC PRICES

Thank you for your letter of 17 December to Michael Reidy. Attached

After consultations between my Secretary of State, the Chancellor and the Foreign Secretary, BNOC are sending the attached telegram to their suppliers this afternoon.

I am copying this letter to Len Appleyard (FCO) and David Peretz (Treasury).

Yours ever
John

J S NEILSON
Private Secretary

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BNOC's telex to suppliers:

In view of the present uncertainties in world oil markets, we consider it inappropriate at this time to make proposals for the prices to be paid to you as from 1 January 1985. While we cannot in the circumstances undertake to maintain the present prices beyond December 31, we look forward to beginning discussions on pricing arrangements to apply effective 1 January with you as soon as possible.

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

Mr
20/12.

Mr Fletcher: to see
DMB
20/12

Robin Butler Esq
Principal Private Secretary to
The Prime Minister
10 Downing Street
LONDON SW1

20 December 1984

Dear Robin

You should know that the Mexican Embassy have informed us that President de la Madrid wishes to deliver a special message to the Prime Minister. The President's emissary will call on John Guinness tomorrow afternoon to deliver it. Since this Department was asked to receive the message, we assume that it will be about developments in the oil market.

We will send a report in due course. The FCO have of course been informed.

Yours sincerely

M F REIDY
Private Secretary

EJ DEC 1984

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bcc: J. Wybrew

10 DOWNING STREET

From the Private Secretary

17 December, 1984

BNOC: Oil Prices

The Prime Minister has seen the Chancellor's letter to your Secretary of State of 11 December, his reply of 14 December and the Foreign Secretary's minute of 14 December.

The Prime Minister believes that BNOC cannot be allowed to remain in a position where it is exposed to very large losses and that some change to the way it conducts its operations is therefore required. Nevertheless, she recognises the force of the arguments against announcing any changes before this week's OPEC meeting.

As soon as the outcome of the meeting is known, the Prime Minister wishes action to be taken, preferably in time to take effect from 1 January, to modify BNOC's pricing system. She agrees with the Foreign Secretary that careful presentation of such a change will be required.

I am copying this letter to David Peretz (Treasury), Len Appleyard (Foreign and Commonwealth Office) and Richard Hatfield (Cabinet Office).

ANDREW TURNBULL

JB.

Michael Reidy, Esq.,
Department of Energy

10 DOWNING STREET

From the Private Secretary

(1)

Prime Minister

BNOC Prices

One way through this is a minute saying

(i) BNOC's losses cannot be allowed to continue

(ii) no action before OPEC meeting

but (iii) action must be taken, to take effect no later than 1 January, to get BNOC out of its loss making position

with (iv) a careful presentation of our actions as suggested by Foreign Secretary

Agree? Yes

AT

14/12

FCS/84/327

CHANCELLOR OF THE EXCHEQUER

BNOC Oil Prices

1. I have seen your letter of 11 December to Peter Walker about BNOC pricing.

2. In principle I see advantage in moving to a flexible market related pricing system. This should in the long term enable us to avoid both the commercial and the political disadvantages of the present pricing system.

3. Nevertheless, we face a timing problem in the short term. Any change in the status quo which effectively reduces BNOC prices will be presented as a factor destabilising an already weak market and could cause us serious difficulties with other oil producing countries, in many of which substantial UK commercial and political interests are at stake. We cannot hide behind changes by others, as we could in October, and claims would be made that we were leading prices down.

4. Any action will therefore require very careful presentation to OPEC, particularly to Saudi Arabia and Nigeria. I would regard it as essential to inform the Oil Minister of OPEC member countries and others (Mexico, Oman) of our actions and explain the rationale shortly in advance of, or at least not later than, an announcement. In some cases, for example Shaikh Yamani, a personal message from Peter Walker would also be appropriate.

5. Priority should be given to considering how best to present a decision to the other producers. In practice I think we should do best to act after the OPEC meeting on 19 December, and adapt the presentation of our decision to

/take

take account of the measures decided by OPEC at it.

6. I am copying this minute to the Prime Minister and to Peter Walker.

GEOFFREY HOWE

Foreign and Commonwealth Office
14 December 1984

14 DEC 1984

CONFIDENTIAL

CC/NO

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

14 December 1984

Dear Nigel

BNOC: OIL PRICES — WHAT?

I have received your letter of 11 December. We have consistently taken the position, both while you were Secretary of State for Energy and since, that BNOC are price followers and not price leaders. I believe that it would be the height of folly to reverse this basic tenet of our policy at this particular juncture. Whatever approach we decide to adopt to BNOC's future pricing, I am sure that we should only decide and announce this after the OPEC meeting on 19 December. In any case there is not enough time to complete all the necessary consultations before the OPEC meeting.

As Alick Buchanan-Smith pointed out to the Select Committee on Energy yesterday evening, there are a number of very important uncertainties at the moment, which would make an immediate decision most imprudent. I have already mentioned the OPEC meeting, which will consider not only prices and quotas, but the key question of differentials. Secondly, we need to evaluate Statoil's reported decision not to set a term price for December sales, which was announced yesterday. Thirdly, you will no doubt have seen Peter Baxendell's remarks about the likelihood of the market position being changed very significantly before the end of a year, when he is forecasting a bear squeeze on oil prices - you will recall that last year the market only hardened in late December. Whatever is decided about BNOC's price beyond the end of the year, it is highly desirable, if at all possible, that any announcement should be made against the background of a hardening market and not in the present uncertain conditions.

I imagine that your letter was written before you had had time to consider Yamani's remarks reported in yesterday's newspapers. I believe these must be taken very seriously. Even if we are eventually forced to announce unpalatable decisions, it is surely only common-sense to do so when we are in a position to point to the inadequacy of OPEC's own performance.

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In short, I believe we should continue to consider all the options, but only aim to reach decisions and allow BNOC to make announcements right at the end of the year. I take your point about public expenditure, but the public expenditure risks are totally dwarfed by the risk to your revenue if, by leading the market, we should push down prices gratuitously. And, as you know, some 80% of the public expenditure is anyway recovered in tax from the oil companies.

I am sending copies of this letter to the Prime Minister and Geoffrey Howe.

PETER WALKER

CONFIDENTIAL

14 DEC 1984

CONFIDENTIAL

MR TURNBULL 12 December 1984

BNOC: OIL PRICES

As the Chancellor points out in his letter of 11 December to Peter Walker, the timing of a move by BNOC to formula pricing is a particularly difficult tactical judgement in relation to the OPEC meeting on 19-20 December. He concludes that it is desirable for BNOC to announce its intentions ahead of that meeting so that OPEC can take their decisions in the full knowledge of BNOC's move.

We should be wary of endorsing that conclusion. Rather than seeing an early move by BNOC as unpalatable, but nonetheless an act of fair play, Yamani and the principal OPEC Ministers are more likely to see it as an act of provocation which undermines the basis of their meeting.

The forthcoming OPEC meeting has been convened to tackle the long-outstanding problem of outdated price differentials between crudes of different quality. Yamani has been chairing a sub-committee to prepare the ground for this. The only hope of a re-alignment of differentials is upwards relative to the Saudi marker price. That can only be achieved in a hard market. Saudi Arabia has been striving towards a hardening of the market by reducing its oil production from 5.3 million b/d in the first quarter of 1984, to 3.8 million b/d now. The rest of OPEC have been surprisingly disciplined and supportive, at least on volume controls. The mild northern

Winter has not helped them, nor has the increase of UK North Sea production from 2.4 million b/d in the Summer to 2.6 million b/d now.

With the oil market still unfavourably weak and nervous, Yamani and his sub-committee already face a daunting task at their meeting next week. Against that background, a prior statement of a change of pricing policy by BNOC would probably be perceived as a body blow.

Taken, say, two weeks or more after the OPEC meeting it could at least be presented as a vote of confidence in OPEC's continuing efforts to maintain price stability. In any case, we shouldn't rule out the possibility of a sharp hardening of the market around the end of the year. Stocks are exceptionally low. A cold snap could send oil buyers rushing into the market.

JOHN WYBREW

7.60

CONFIDENTIAL

Prime Minister (2)

Following this afternoon's discussion, the Chancellor has lost patience with Mr Walker. To await Mr Walker's response

AT 11/12

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

11 December 1984

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1

Dear Secretary of State,

BNOC: OIL PRICES

Since we agreed in October to the cut in BNOC prices, there has been a further significant weakening of the oil market. We now face another delicate decision in setting BNOC's prices for the next quarter. We discussed this earlier today.

I am concerned about two aspects of this position. First, as long as spot prices are below the BNOC price, BNOC will make losses. As I understand it, at present price relativities, BNOC is now entering into commitments which are building up losses at a rate of over $1 million a day. This adds to public expenditure.

We have in the past been willing to see this happen for short periods rather than respond to volatile movements in the market. There seems little reason to believe that the oil market will be any stronger in coming months.

This brings me to my second concern. If we continue with our present quarterly administrative price fixing, we will find ourselves having to tackle further downward adjustments to BNOC prices. This attracts diplomatic and economic pressure we could well do without.

In your letter of 17 October, you raised the possibility of moving to a flexible market related pricing system using a formula based on spot prices. This would enable BNOC to keep its prices more closely in line with the market, and so prevent it incurring large-scale losses. It should also obviate the need for us to take regular pricing decisions, and so reduce the diplomatic and economic pressures on us. I understand that BNOC now favour this approach.

Obviously the timing of any move of this sort requires very careful judgement. But it is vital that the new arrangements

are in place with effect from 1 January 1985.

There is a particularly difficult tactical judgement in relation to the OPEC meeting on 19-20 December. In my view it is desirable that BNOC announces its intentions ahead of that meeting so that OPEC take their decisions in full knowledge of BNOC's move. If they take their decisons first, and then BNOC change course, the market will have little faith in the OPEC outcome (since it will have been overtaken by events) and the Saudis are likely to feel that we have let them down. So I think we should move now.

I am copying this letter to the Prime Minister and Geoffrey Howe.

Yours sincerely

NIGEL LAWSON

(Approved by the Chancellor, and signed in his absence)

CONFIDENTIAL

MBPM AT 7/12

MR TURNBULL

7 December 1984

MID-DECEMBER OPEC MEETING AND THE STATE OF THE OIL MARKET

In case you should want to brief the Prime Minister, the background to the forthcoming OPEC meeting is broadly as follows:

1) The mild northern November has reduced oil demand by roughly 0.5 million b/d.

2) Following their October meeting, OPEC members have achieved a surprising degree of discipline in curbing total production to some 16.3 million b/d.

3) On the other hand, some OPEC members, eg Iran and the United Arab Emirates, have not had the nerve to stop giving price discounts in order to sell their full production entitlement. This has frustrated a hardening of prices. Anticipating the possibility of lower oil prices in the immediate future, oil companies have been induced to dip deeper into their already low stocks, thus reinforcing the weakness of the market.

4) It is widely assumed that BNOC and the Norwegians will keep out of the limelight until after the OPEC meeting so as to avoid unsettling a nervous market. Even so, OPEC will have little room for manoeuvre in tackling the principal aim of the meeting - the re-alignment of

outdated price differentials. At most, there could be some token tinkering. For the rest, they will reinforce discipline over production allocations.

5) Barring the unforeseen, this implies little change in the state of the oil market through the remainder of the Winter.

6) However, there may be some brighter news. The International Energy Agency is now estimating that commercial oil stocks in the industrialised countries will have fallen to the equivalent of only 71 days forward consumption by the start of 1985. This would be the lowest level since the supply crisis in 1979. It suggests that by the Spring of next year, when the official OPEC price structure would normally be under the greatest downward pressure, the industry will have exhausted all possibility of drawing down stock in anticipation of falling oil prices. That will make OPEC's balancing act easier.

You could say that the oil market is suffering from a prolonged cold now, but should be spared a dangerous fever in the Spring.

JOHN WYBREW

NCPM
AF 12/11

Price Markets: (

CONFIDENTIAL

Peter Walkers letter (attached) is the reply to earlier comments. Do you think that it is worth returning to the charge as the policy Unit proposed?

MR TURNBULL

9 November 1984

NP

BNOC

Peter Walker's reply to your letter of 17 October defends the status quo on grounds of consistency. Following the recent oil price shake-up his Department believe that BNOC is set to return from bankruptcy to a satisfactory trading operation.

The oil market is likely to remain weak and over-supplied for at least the next year or two. Also, the changing structure of the market makes it more prone to volatility. In these circumstances, if BNOC continues to intervene between producers and oil buyers, it stands to cost the Exchequer tens of millions of pounds per year and perhaps more.

Against this, it is difficult to set any worthwhile benefits which cannot be achieved as easily without BNOC. The price stabilisation argument is no longer sustainable. Taking royalty in oil rather than cash is worth around £30 million per year to the Government. The oil companies would as soon keep the oil, pay cash and let the Government continue to realise this benefit.

The political flack in dismantling BNOC will come from the question of oil supply security in a crisis. In such circumstances, BNOC would probably be impeded by its term contracts with overseas buyers. At best, its contribution

would represent belt and braces. Firstly, we would be covered by the IEA oil sharing arrangements, and behind those we have emergency powers under the Energy Act.

Is it not time to wind up this whole operation, save the money and get us out of the difficulty of trying to second-guess unpredictable oil markets? We should not be fobbed off by Energy's unwillingness to confront the need for change in face of new circumstances.

JOHN WYBREW

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NBPM AT 1/11

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

01 211 6402

Andrew Turnbull Esq
Private Secretary to the
Prime Minister
10 Downing Street
London
SW1

29 October 1984

Dear Andrew

BNOC: OIL PRICES

Thank you for your letter of 17 October.

My Secretary of State will certainly be reviewing the whole oil scene in the light of the outcome of today's OPEC meeting. At the moment it does look as if the action we have taken on North Sea oil prices has pushed OPEC towards putting their own house in order, which is in the present circumstances the only way a sharp fall in the market is likely to be avoided. The prospect that OPEC will try to do this has helped the market. Our move seems also to be leading to more realistic differentials between light and heavy oil, inside OPEC as well as outside it.

As to BNOC, it was of course as recently as 1 August, following extensive consultation between interested Departments, that my Secretary of State announced on behalf of the Government its conclusion that BNOC ought to be retained - "the Corporation has made an effective contribution, which I wish to continue, to ensuring that the nation derives full benefit from the exploitation of oil from the United Kingdom Continental Shelf". My Secretary of State would see some risk to the Government's reputation for consistency and stability of policy if there were to be an early announcement that the 1 August decision had been reversed. And the actions taken through BNOC in 1983 and 1984 appear to have served UK interests well. But my Secretary of State will certainly keep the whole field under close review.

I am copying this letter to David Peretz, Peter Ricketts, and Callum McCarthy.

Yours sincerely

M F REIDY
Private Secretary

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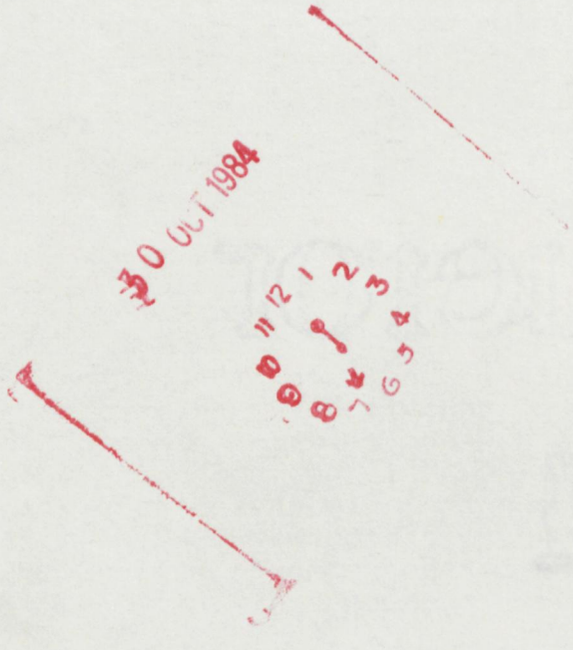
Energy: North Sea Oil Prices Pt 2



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TO IMMEDIATE FCO
TELNO 913 OF 19 OCT
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Summary only.

SAVING TO TRIPOLI, LIBREVILLE.

TELECON WORDSWORTH/RESIDENT CLERK AND MY TELNO 904 (NOT TO ALL):
NIGERIAN PRICE CUT

SUMMARY

1. PRICE OF NIGERIAN LIGHT CRUDES REDUCED BY DOLLARS 2 PER BARREL. SMALLER PRICE CUTS FOR HEAVIER CRUDES. APPARENTLY A SNAP DECISION, WITH LITTLE CONSULTATION WITH OPEC. NO HOSTILITY TOWARDS UK SO FAR.

DETAIL

2. IN A PRESS CONFERENCE ON 18 OCTOBER THE NIGERIAN MINISTER OF PETROLEUM AND ENERGY, PROFESSOR TAM DAVID-WEST, ANNOUNCED THAT THE PRICE OF NIGERIAN BONNY LIGHT CRUDE IS TO BE REDUCED BY 2 DOLLARS PER BARREL WITH IMMEDIATE EFFECT. SIMILAR REDUCTIONS HAVE ALSO BEEN INTRODUCED FOR OTHER LIGHT CRUDES. THE PRICE OF THE HEAVIER FORCADOS IS REDUCED BY DOLLARS 1.50 PER BARREL: BONNY MEDIUM BY 1 DOLLAR.

3. NEW PRICES ARE AS FOLLOWS (OLD PRICES IN BRACKETS):

BONNY LIGHT	28	(30)
BRASS BLEND	28	(30)
QUA IBOE LIGHT	27.95	(29.95)
ESCRAVOS LIGHT	27.90	(29.85)
PENNINGTON LIGHT	27.90	(29.85)
FORCADOS BLEND	27.50	(29)
BONNY MEDIUM	27	(28)

4. REDUCING PRICES NOW, RATHER THAN WAITING FOR THE 29 OCTOBER OPEC MEETING, APPEARS TO HAVE BEEN A SNAP DECISION, POSSIBLY REFLECTING DISCUSSIONS AT THE REGULAR THURDSAY MEETING OF THE MINISTERIAL FEDERAL EXECUTIVE COUNCIL. DAVID-WEST CLEARLY IMPLIED TO ME ON THE EVENING OF 17 OCTOBER (MY TELNO 904) THAT NIGERIA WOULD TRY TO HOLD BACK FROM ANY UNILATERAL PRICE CUT, AND WAIT FOR COLLECTIVE OPEC ACTION. THE PUBLIC AFFAIRS MANAGER OF NNPC APPARENTLY GAVE THE SAME INDICATION TO A LOCAL NEWSPAPER ON THE MORNING OF 18 OCTOBER, SAYING THAT NIGERIA WAS NOT LIKELY TO TAKE ANY PRECIPITATE ACTION.

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15

5. AT HIS PRESS CONFERENCE, DAVID-WEST INDICATED THAT NIGERIA HAD FOREWARNED OTHER OPEC COUNTRIES OF ITS MOVE. HE INDICATED, HOWEVER, THAT THERE HAD BEEN LITTLE, IF ANY, REAL CONSULTATION, SAYING THAT WHILE NIGERIA WAS ALWAYS PREPARED TO HONOUR ITS COMMITMENTS TO OPEC, ''WE ARE ALSO CONSCIOUS OF OUR RESPONSIBILITIES TO OUR PEOPLE .... NIGERIA HAS ALWAYS RESISTED TO ACT (SIC) IN DESPERATION DESPITE THE HARSH ECONOMIC PROBLEMS WE FACE OBVIOUSLY THERE IS A LIMIT TO SUCH SACRIFICE''. HE HOPED THAT OPEC ''WILL UNDERSTAND OUR PRESENT ACTION, CONSIDERING THE SUDDEN TURN OF EVENTS WHICH HAS COMPELLED US TO ACT IMMEDIATELY IN THE INTEREST OF OUR PEOPLE''.

6. LOCAL PRESS COVERAGE HAS SO FAR CONSISTENTLY MADE CLEAR THAT BNOC'S PRICE CUT WAS IN RESPONSE TO THE NORWEGIAN MOVE. THERE HAS BEEN NO HOSTILE COMMENT DIRECTED AT THE UK. A PERSONAL LETTER FROM DAVID-WEST, IN RESPONSE TO MINE TO HIM OF 18 OCTOBER (TUR REFERS), WAS DELIVERED TO THE HOUSE THAT SAME EVENING (COPY BY BAG). IT REFERRED IN WARM TERMS TO OUR EARLIER TELEPHONE CONVERSATION, AND SAID THAT, FOLLOWING LONG DISCUSSIONS WITH HIS EXPERTS, ''CERTAIN DECISIONS HAVE BEEN TAKEN'', DETAILS OF WHICH WOULD BE RELEASED AT THE PRESS CONFERENCE. THE LETTER SAID THAT HE WAS GIVING ME ADVANCE WARNING IN ''THE SPIRIT OF OUR MUTUAL UNDERSTANDING ON OUR COMMODITY: OIL''.

7. IN ANSWER TO A QUESTION AT HIS PRESS CONFERENCE, DAVID-WEST REVEALED THAT HE HAD BEEN INFORMED OF BNOC'S PRICE CUT BY ME BEFORE IT WAS ANNOUNCED.

8. THE LOCAL MD OF SHELL HAS TOLD US THAT HE WAS EXPECTING A PRICE CUT. BUT HE THOUGHT THAT THE NIGERIANS' MOVE WENT TOO FAR AND COULD ONLY PUT THIS DOWN TO NIGERIAN ''JUMPINESS'' ON THIS ISSUE.

FCO PLEASE PASS SAVING ADDRESSEES.

(REPEATED AS REQUESTED)

WYATT

[OIL]

STANDARD ~~(PALACE)~~

ES & SD	**MCAD**
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TRED	**SEAD**
ESID	**WED**
ECDS	**MR J THOMAS**
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NENAD	**MR EGERTON**
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YOUR TELNO 416 TO JEDDA AND 664 (TO LAGOS ONLY):
BNOC: OIL PRICES

SUMMARY.

NIGERIAN OIL MINISTER REACTS CALMLY AND WITHOUT RECRIMINATION TO BNOC'S DECISION TO CUT THEIR OIL PRICE.

1. PROFESSOR DAVID-WEST, THE MINISTER FOR PETROLEUM AND ENERGY, WAS CLOSETED IN MEETINGS BUT I WAS ABLE TO HAVE A QUICK WORD WITH HIM ON THE TELEPHONE YESTERDAY EVENING, 17 OCTOBER. HE HAD HEARD A FEW MINUTES EARLIER ABOUT BNOC'S ACTION AND SAID HE WAS IN CONSTANT TOUCH WITH HIS OPEC COLLEAGAES, HAVING

AS TO SEVERAL OTHER OPEC OIL MINISTERS. DAVID-WEST SAID THAT OPEC WOULD REACT TO THE LATEST DEVELOPMENTS ON A COLLECTIVE BASIS AND IT WAS VIRTUALLY CERTAIN THAT THERE WOULD BE AN OPEC MINISTERIAL MEETING IN GENEVA ON 29 OCTOBER TO DECIDE WHAT, IF ANYTHING2 SHOULD BE DONE. PERSONALLY, HE WAS OPTIMISTIC THAT THE SITUATION COULD BE CONTAINED.

2. DAVID-WEST THANKED ME WARMLY FOR HAVING CONTACTED HIM AND ASKED THAT HIS PERSONAL APPRECIATION SHOULD BE CONVEYED TO THE SECRETARY OF STATE FOR ENERGY, WHO, DAVID-WEST SAID, HAD KEPT TO HIS UNDERTAKING TO KEEP NIGERIA INFORMED ON THESE MATTERS.

3. ALTHOUGH I WAS ABLE TO RUN BRIEFLY THROUGH THE POINTS IN THE SECOND TUR, THERE WAS NOT TIME TO DRAW ON PARAS 9 - 14 OF THE FIRST TUR. I TOLD DAVID-WEST, THEREFORE, THAT I WOULD LET HAVE FURTHER VIEWS IN WRITING AND I AM FOLLOWING UP WITH A LETTER TO HIM TODAY.

WYATT

CONFIDENTIAL

9R 131
CONFIDENTIAL
FROM RIYADH 171948Z OCT 84
TO FLASH FCO
TELEGRAM NUMBER 131 OF 17 OCTOBER
INFO PRIORITY JEDDA

BNOC PRICES : YOUR TELNO 416 TO JEDDA
FROM AMBASSADOR IN RIYADH

1. I SPOKE THIS EVENING TO SHEIKH YAMANI AND CONVEYED TO HIM THE TEXT IN YOUR TELNO 417.
2. YAMANI THANKED ME FOR MR WALKER'S MESSAGE BUT SAID IT CAME AS A SUPRISE TO HIM AND THAT HE COULD FRANKLY SEE NO JUSTIFICATION FOR BNOC'S MOVE AT A TIME WHEN THE OIL MARKET COULD BE EXPECTED TO STRENGTHEN. HE SAID THAT HE HAD ALREADY TRIED TO CONTACT MR WALKER BY TELEPHONE TODAY AND HOPED TO BE ABLE TO SPEAK TO HIM SOON IN ORDER TO DISCUSS HIS MESSAGE WITH HIM. I TOLD HIM THAT I WAS OF COURSE AVAILABLE TO DISCUSS THE MESSAGE FURTHER WITH HIM MYSELF , BUT HE WAS IN SOMETHING OF A HURRY AND HAS NOT TAKEN UP THE OFFER.
3. I AM ARRANGING FOR TEXT OF MESSAGE TO BE DELIVERED IN WRITING TO SHEIKH YAMANI .

MUIR

[OIL]

STANDARD ~~(PALACE)~~

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10 DOWNING STREET

From the Private Secretary

17 October 1984

Dear Michael.

BNOC: OIL PRICES

The Prime Minister has seen your Secretary of State's letter to the Chancellor of 17 October proposing that BNOC should cut the price of its crudes by $1·35-1·50 per barrel (you indicated subsequently that the proposed cut would be at the bottom end of this range). The Prime Minister is content with this.

She has commented, however, that the continued existence of BNOC has, on a number of occasions recently, put the spotlight on the Government and forced it into the position of having to take difficult decisions on oil prices. It was agreed in correspondence last June that the future of BNOC should be reviewed in about two years's time. The Prime Minister considers that, in the light of recent developments, this question should be re-opened now to see whether the the difficulties for the Government generated by BNOC's existence are outweighed by the benefits it brings.

I am copying this letter to David Peretz (HM Treasury), Peter Ricketts (Foreign and Commonwealth Office) and Callum McCarthy (Department of Trade and Industry).

Yours sincerely

Andrew Turnbull

SECRETARY OF STATE FOR ENERGY'S OFFICE
RECEIVED
18 OCT 1984

ANDREW TURNBULL

Michael Reidy, Esq.,
Department of Energy.

3.21

CONFIDENTIAL

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

17 October 1984

Michael Reidy Esq
Private Secretary to the
Secretary of State for Energy
Thames House South
Millbank
LONDON SW1

Dear Michael,

This is to confirm, as I told you over the telephone, that the Chancellor is content with the proposals in your Secretary of State's letter of 17 October. In particular he is sure it is right to make the move today.

He also believes there is a strong case for moving to a formula based approach in due course, and is glad, therefore, that officials will be continuing work on this.

I am copying this letter to Andrew Turnbull (No 10), Peter Ricketts (FCO), and Callum McCarthy (DTI).

Yours sincerely,

Philip Wynn Owen.

D L C PERETZ
Principal Private Secretary

CONFIDENTIAL

Foreign and Commonwealth Office

London SW1A 2AH

17 October 1984

Dear Michael,

BNOC: Oil Prices

As I have told you on the telephone, the Foreign Secretary has no objection to the proposal in Mr Walker's letter of 17 October to Mr Lawson that BNOC should propose to its customers and suppliers a price cut matching the Norwegians'.

The Foreign Secretary considers that it is essential that our Missions abroad should be in a position to give the news to the major oil exporting countries in advance of BNOC's communication of its new price to their companies. I understand that Mr Walker already has it in mind to send a message to Sheikh Yamani. The Foreign Secretary believes that messages to Nigeria, Mexico and Venezuela in particular would also be essential. Our officials are in touch about the mechanics of this.

The Foreign Secretary also believes that officials should be asked to examine urgently the best way of dealing with the question of changed differentials, to which Mr Walker referred in his letter of 21 September to Mr Lawson. This problem is pressing because the effect of BNOC's reduction may be further reductions by other producers which will leave the problem of differential prices unchanged.

I am copying this letter to Charles Powell (No 10), David Peretz (HM Treasury) and Callum McCarthy (DTI),

Yours ever,

Peter Ricketts

(P F Ricketts)
Private Secretary

Michael Reidy Esq
PS/Secretary of State
Department of Energy

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

CONFIDENTIAL

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3AG

17. October 1984

BNOC: OIL PRICES

Since I wrote to you on 21 September, there have been three significant developments in the world oil market. I judge that the time is now right for BNOC to reduce its prices.

The Saudis have changed the composition of the export mix - in effect undercutting BNOC by a further 50¢/bbl. The further strengthening in the market we had earlier hoped for is therefore now unlikely to take place. The threats by the UAE to reduce prices unilaterally are further unsettling the market. Most important, the Norwegians are reported to have cut their price, some grades of which are also sold by BNOC, by $1.35 - 1.50/bbl. This has caused a further fall in North Sea spot prices and increased the pressure on BNOC. But it has also presented us with a natural opportunity for a change in BNOC's prices without BNOC leading prices down.

We can now either make a straight price cut or, more radically, move to a flexible market-related price whose level could be determined by a formula based on spot prices. There is merit in the latter, but it is not a natural market development. It would clearly and correctly signal that the UK saw no prospect for the time being of playing a direct role in price-setting in the interests of market stability. A price cut by BNOC is not free of risk; but equally pricing by a formula could add to the weakness and uncertainty in the market.

I believe, and the Corporation agrees, that a straight price cut matching the Norwegian cut is now the best way of restoring the BNOC price to a competitive level. That would not rule out later resort to a formula approach should such a straight price cut fail to stabilise the market. I have asked BNOC and officials, therefore, to continue their work on such an approach.

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Because the Norwegians have cut their prices BNOC should now move as quickly as possible. If it does not, market speculation will build up, and it will become more difficult for the Corporation to act without destabilising the market. Spot prices have already fallen by $0.70/bbl since the news of the Norwegians price cut became known. Moreover the sooner BNOC moves, the more surely we can transfer the odium to Norway. I should therefore be grateful for your agreement to the Corporation proposing to its customers and suppliers a price cut matching the Norwegians. The Corporation should make its proposals today : I should therefore be grateful if you could let me have your views by 3pm.

I am copying this letter to the Prime Minister, Foreign Secretary and Secretary of State for Trade and Industry.

PETER WALKER

Agreed but
Please review
now B.N.O.C's
Could evidence. It seems
to put us in an
embarrassing position - because
we have to decide on oil prices.
pw

17 OCT 1984

7.37

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NBPT
AT
10/10 CCNO

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

9 October 1984

The Rt. Hon. Peter Walker MBE MP
Secretary of State for Energy

Dear Peter

BNOC PRICES

I have now had a chance to consider your letter of 21 September, which arrived while I was in Washington.

Given the importance of North Sea oil prices to the economy, the PSBR and public expenditure, I am sorry that you did not, as is usual, consult the Treasury before taking your decision on BNOC's fourth quarter prices.

In the event I was quite content with the decision taken. But I should take this opportunity to record my concern about the mounting public expenditure cost of continuing to keep the BNOC price well above the market price. We clearly cannot allow this to go on for very much longer; and I am sure you have it in mind to bring proposals forward soon.

I am sending copies of this letter to the Prime Minister and Geoffrey Howe.

Yours Nigel

NIGEL LAWSON

Energy Pt 2

Oil Prices

10 OCT 1984

CONFIDENTIAL

NBPM

AT 1/16

Foreign and Commonwealth Office

London SW1A 2AH

From The Minister of State

28 September 1984

OIL PRICES

You sent Geoffrey Howe, who is as you know in San Jose, a copy of your letter to Nigel Lawson of 21 September about BNOC's fourth quarter pricing.

You mention possible technical changes in setting prices for UKCS crudes. Any such changes would of course have implications for our relations with other oil producers and I should be grateful if our officials could keep in close touch about this.

I am sending copies of this letter to the Prime Minister and the Chancellor of the Exchequer.

Yours

Pam

Baroness Young

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy

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ENERGY: Oil Prices Pt 2 Pt 2

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~~RESIDENT CLERK~~

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MR HIGSON)

MR FREEMANTLE)
MISS PENNY BOYS)THAMES HOUSE
MS CAMERON)SOUTH
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MR B URWIN)
MR R LAVELLE)HM TREASURY
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MR GRAHAM HARRISON) ODA

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TO IMMEDIATE F C O

TELEGRAM NUMBER 070 OF 26 SEPTEMBER

AND TO TREASURY

AND TO DEPARTMENT OF ENERGY

OPEC MONITORING COMMITTEE MEETING, VIENNA

1. THE OPEC MONITORING COMMITTEE, AFTER A SHORT SESSION TODAY, DECIDED TO RECOMMEND THAT BOTH THE PRESENT OVERALL OPEC PRODUCTION LIMIT OF 17.5 MILLION BARRELS PER DAY AND THE CURRENT MARKER CRUDE PRICE OF DOLLARS 29 PER BARREL SHOULD BE MAINTAINED.

2. IN A STATEMENT MADE AFTER THE MEETING, THE COMMITTEE CHAIRMAN, OTAIBA, STATED FIRMLY THAT OPEC IS PREPARED TO DEFEND THE PRICE AT ALL COSTS EVEN IF THIS WERE TO INVOLOVE REDUCING PRODUCTION QUOTAS. HE CLAIMED THAT STRONG, ARTIFICIALLY GENERATED, PRESSURE HAD BEEN BROUGHT TO BEAR ON THE MARKET, PARTICULARLY DURING THE FIRST HALF OF AUGUST BY CERTAIN NON-OPEC CONSUMERS, PRODUCERS AND OIL COMPANIES. HE STATED THAT OPEC WOULD CONTINUE TO RESIST PRESSURE OF THIS SORT.

OPEC WOULD CONTINUE TO RESIST PRESSURE OF THIS SORT.

3. THE FOLLOWING POINTS EMERGED WHEN OTAIBA ANSWERED QUESTIONS FROM THE PRESS:

A) ESTIMATED CURRENT OPEC PRODUCTION IS ABOUT 16.5 MILLION BARRELS PER DAY WITH SEVERAL OPEC COUNTRIES PRODUCING LESS THAN THEIR QUOTA.
B) THE MARKET IS EXPECTED TO IMPROVE DURING THE 4TH QUARTER WITH THE DEMAND FOR OPEC OIL RISING BETWEEN 18.8 AND 19 MILLION BARRELS PER DAY. NO SPECIAL MEASURES HAVE BEEN AGREED SO FAR TO DEAL WITH THE ANTICIPATED INCREASE.
C) WITHOUT BEING SPECIFIC, OTAIBA ADMITTED THAT THE COMMITTEE HAD CONSIDERED SEVERAL PRICE AND QUOTA VIOLATIONS WITHIN OPEC. THE GOVERNMENTS OF THE COUNTRIES CONCERNED HAD BEEN TACKLED AND PROMISES OF MORE DISCIPLINED BEHAVIOUR RECEIVED.
D) THE INCREASING STRENGTH OF THE DOLLAR, IT WAS CLAIMED, HAD BEEN A DISADVANTAGE RATHER THAN A BENEFIT SINCE THE RESULTING INCREASED COST TO CERTAIN CONSUMERS HAD SUPPRESSED DEMAND.
E) THE QUESTION OF DIFFERENTIALS WAS NOT DISCUSSED. THIS IS A COMPLICATED ISSUE AND MORE EXPERT OPINION IS REQUIRED BEFORE RECOMMENDATIONS CAN BE MADE.
F) THE QUESTION OF NIGERIA'S QUOTA FOR OCTOBER AND THEREAFTER WAS NOT DEALT WITH BY THE MONITORING COMMITTEE.
G) WHEN QUESTIONED ABOUT BARTER DEALS OTAIBA CONDEMNED THE PRACTICE BUT IMPLIED THAT SEVERAL INSTANCES OF THIS PRACTICE HAD COME TO THE NOTICE OF THE COMMITTEE.

4. THE MONITORING COMMITTEE WILL NEXT MEET ON THE 16TH OF NOVEMBER IN GENEVA.

MORGAN

NNNN

SENT AT 27/0650Z JVH

CONFIDENTIAL

NBPM AT 24/9

cc: NAT IND: Gas+ Electricity.

24 September 1984

MR TURNBULL

BNOC PRICES

We agree with the analysis set out in Peter Walker's letter to the Chancellor.

The agonising over price differentials and BNOC's term custom just underlines the undesirability of keeping BNOC in its current form.

The Prime Minister might write approving the approach and reminding Energy of the need to examine BNOC's future again in the light of recent problems.

ELECTRICITY: NEXT FINANCIAL TARGET

Peter Walker's letter on this subject also has considerable justice in it. The replacement cost of assets in an industry as over-provided with plant as the electricity industry is a very academic concept.

What matters politically is:

a. a reasonable level of price increase for electricity, so that we do not incur the disopprobrium of back-door taxation;

CONFIDENTIAL

b. an effective means of applying pressure to the cost base of the industry, so that more profit and more cash flow can be generated for the public sector for a given level of revenue;

c. the Treasury are not undermined in their energy bilateral which is seeking substantial cash benefits from the electricity EFL.

The debate concerning all of the nationalised monopolies, including electricity, gas and water, should concentrate on the systems in place for enforcing detailed unit costings, for exerting pressure for greater economies of scale to be delivered, more asset sales, and better control of working capital.

JOHN REDWOOD

CONFIDENTIAL

CC(84)

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

22 August 1984

The Rt Hon Alick Buchanan-Smith MP
Minister of State
Department of Energy
Thames House South
Millbank
London SW1

NBPM

Dear Minister of State,

WORLD OIL MARKETS

You wrote to me on 15 August, setting out the measures you planned to take to reduce the pressure on BNOC.

I am prepared to agree to your proposals with one reservation. I am reluctant for you to enter into discussions with Shell on the lines suggested. Storing oil has few attractions and many drawbacks. However, I would not object if you thought it helpful to indicate to Shell that were they to produce specific proposals, we might be prepared to consider extended credit terms for storage at times of market weakness. But we must ensure Shell do not regard this as a commitment, since any decision to introduce such a scheme could only be taken in the particular circumstances of the time.

We have had to take decisions very quickly on this occasion. I think this underlines the need to keep the Treasury fully informed of developments in the oil market so that we are in a position to respond swiftly, and it goes without saying that it is helpful for us to have as much warning as possible of any proposal which might affect the level of oil prices.

I am copying this letter to the Prime Minister, Geoffrey Howe, Norman Tebbit and Sir Robert Armstrong.

Yours sincerely

Margaret O'Mara

NIGEL LAWSON

(approved by the Chancellor and signed in his absence)

315.27

Gravy PT 2

Waldorf Market

CONFIDENTIAL

Prime Minister (2)

Mr Walker has persuaded BNOC not to cut its prices by $1 pb barrel. Though this means losses for BNOC this is made up for by Exchequer by extra tax revenue

AT
21/9

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

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

21 September 1984

OIL PRICES

Following my recent agreement with the Chief Secretary about BNOC financing, I am writing to you about the Corporation's pricing policy for the 4th Quarter. I have sought the views of Shell, Esso, BP, Texaco and Mobil on the likely development of the market over the next 3 months.

There is a wide range of agreement amongst the major integrated oil companies, although Mobil have a somewhat more pessimistic assessment of the market than the other 4 companies. First, there is widespread agreement that the supply sides of the large oil companies are taking a much shorter term view than even a few months ago. Rather than taking, say, a 3 month view they are looking only 2 or 3 weeks ahead. Secondly, they agree that, because of this shortening of horizons and because Europe is now receiving the over-production from the Gulf in July, the market is weaker than fundamentals would justify. Normally companies would now be stocking up for the winter. They are in fact destocking. Thirdly, the companies other than Mobil expect a marked tightening of the market sime time during the next 4-6 weeks. Market perceptions that the winter is upon us and that supplies are unusually low could arise very rapidly with consequential effects on spot prices. Of course, if OPEC were to grant themselves increased quotas next week, these forecasts of hardening prices might not materialise.

Several companies, notably Shell, Esso and BNOC, have also drawn attention to a long term reduction in the market value of lighter crudes compared with the heavier Gulf crudes. The majors, however, notably Shell, Esso and BP, have strongly recommended against a technical reduction of the BNOC term price now. While the oil market is considerably stronger than in July (to the great benefit of the Exchequer) it is still fragile. The companies argue that a cut in the BNOC price now will run a high risk of destabilising the world oil market with adverse effects not only on oil prices but also on sterling and on our relations with OPEC countries. They see such an adjustment as particularly imprudent at a time, when other things being equal, one would expect to see an early strengthening of the market.

CONFIDENTIAL

I see considerable force in this analysis by the major oil companies.

The BNOC Board delayed making a recommendation on 4th Quarter prices until 19 September, although contractually their prices should have been announced on 14 September. They recommended a $1 cut largely to reflect the change in differentials referred to in paragraph 3 above. In doing so, the Board was naturally concerned by their own financial prospects and the need to maintain their term customers in the current difficult market position.

I have discussed this recommendation with Douglas Croham and Ian Goskirk, both of whom accept that the Government might wish to override their Board's recommendation for wider reasons. They did however stress that any delay at this stage could trigger off market rumours such as contributed to the weakness in July.

I believe we would be quite wrong to agree to a cut of $1 in the Brent marker at this juncture. It will incur unnecessarily high risks of destabilising the world oil market just before it is likely to tighten. I accept that asking BNOC to hold their term price will involve them in some further loss of term custom and in further financial losses over the next few weeks. But, so long as BNOC can continue to sell some 20% of its freely tradeable oil at term prices, the gain in tax revenue will outweigh BNOC's losses. There will consequently be a net gain to the PSBR. We also need to take into account the reactions of OPEC countries, to what they would undoubtedly judge an ill-timed and unnecessary price cut and the effects on sterling.

I believe our officials should continue to monitor the position closely. I have asked my officials to give fuller consideration to the optimum way of dealing with the problem of changed differentials. Unless that problem is resolved, BNOC will find it difficult to retain any significant term custom in the longer run. I am convinced, however, that the right time to contemplate any technical change is when the market is harder. A change then is likely to run the least dangers of upsetting the market and provoking retaliatory action from OPEC Governments.

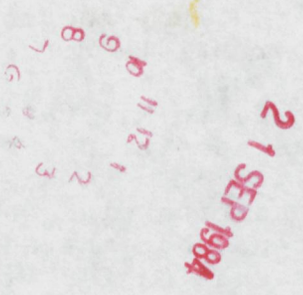
In view of the need to avoid uncertainty, I have told Douglas Croham that BNOC should maintain their current term prices, and they will be telexing their customers and suppliers this evening.

I am sending copies of this letter to the Prime Minister and Sir Geoffrey Howe.

PETER WALKER

ENERGY: Oil Markets

Ptn



SECRET

cc AF

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Foreign and Commonwealth Office

London SW1A 2AH

From The Minister of State

17 August 1984

DMB 17/8

Dear Chancellor of the Exchequer

WORLD OIL MARKET

Alick Buchanan-Smith copied to Geoffrey Howe his letter to you of 15 August outlining a number of measures which he proposes to negotiate with oil companies operating in the United Kingdom Continental Shelf with a view to persuading them to support the efforts of BNOC to hold its prices.

I agree that it is important in terms of our international relations that if a price cut does become inevitable we should be seen to have followed, not led, other oil producing countries.

There are two further comments I would make from the FCO perspective at this stage. I think we need to handle with great care any necessary interventions by the Government more directly with United Kingdom oil companies. Some parts of the press have already commented that our policy is moving closer to that of OPEC member states. The line we have been able to sustain hitherto - that the Government are not involved in market decisions and hence cannot be blamed for the decisions of BNOC or of the oil companies - has served us well. Were this policy to change we would be leaving ourselves open to criticism not only from oil importing countries, who would resent our obstructing a price cut but also, in the longer term, from OPEC countries, who would be able to point to one instance of intervention by HMG when urging us to take similar action in the future.

We need also to have in mind the possible danger of efforts to press the oil companies to adopt a common policy on prices or liftings being regarded in the United States as falling foul of anti-trust laws. We already have enough difficulty with the United States Government over the vexed

/question

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury

SECRET

question of extraterritorial jurisdiction not to wish to add a further set of problems to our commercial relationship.

I hope, therefore, that over the coming weeks there will be close consultation between Departments over the further handling of this problem.

I am sending copies of this letter to the Prime Minister, Norman Tebbit, Alick Buchanan-Smith and Sir Robert Armstrong.

Yours sincerely,

Stewart Clark

for Baroness Young
(approved by the Minister
& signed in her absence)

Energy: Oil Prices Pt2

SECRET

DP
4

DEPARTMENT OF ENERGY
THAMES HOUSE SOUTH
MILLBANK
LONDON SW1P 4QJ
Direct Line 01-211 3290
Switchboard 01-211 3000

Await Chancellor

THE MINISTER OF STATE

The Chancellor of the Exchequer
Treasury
Parliament Street
LONDON
SW1P 3AG

15 August 1984

Dear Chancellor of the Exchequer

WORLD OIL MARKET

In the past fortnight, since Peter Walker wrote to you, spot prices have risen by some $2 though are still up to $1.50 below term prices. BNOC's financial position has eased significantly though its ability to maintain a sufficient volume of term sales remains under threat.

Some part of this strengthening no doubt follows our efforts to bring home to OPEC countries the serious weakness of the market and the need for them to act to strengthen market confidence. By taking steps to persuade companies to support BNOC's efforts to hold its prices, we have given OPEC countries sufficient time to put their house in order.

But the market remains fragile. We need therefore to continue to support the Corporation in its maintenance of prices: if a price cut does become inevitable, we should be seen to have followed, not led other oil producing countries. It is significant that there has still been no major cut in US posted prices, and some of the minor cuts made earlier have been rescinded.

We need therefore to continue to press oil companies not to put BNOC in such a position that it has to make a premature price cut. The interventions we have already made have raised the level of term business that BNOC has been able to keep this quarter from a threatened 29% to 38% of its disposals. There is a good prospect of increasing this to over 50% by persuading companies to accept the package outlined at Annex I. This package which is and has to be defensible on grounds of equity roughly apportions between companies a loss of about one third of the term quantities taken at the beginning of July.

Fortunately we have not had to offer expensive inducements of the kind that appeared might be needed at the time of Peter Walker's letter. The package would save HMG some $15-20m over the remainder of the quarter. There are, however, three elements in it which could have longer term consequences.

Firstly our only possibility of procuring extra term purchases by Texaco (without which the package could fall apart as we could not so readily assure Esso of fair treatment) is by offering to allow them to retain the participation oil which they are currently contracted to sell to BNOC as a consequence of their take-over of Getty. This would not introduce a new principle into participation oil - Shell, Esso, Mobil, BP (for the bulk of its participation oil) and Texaco in respect of the rest of its production already have that right. In the short term it would further reduce BNOC's losses by reducing its avails. It is not possible to foresee the direct financial consequences in the longer term as those will depend on the relationship between BNOC's term price and the market price. But the Inland Revenue advises that it would not cut BNOC's freely disposable avails of the relevant grades of crude oil to levels below those at which the BNOC price would retain its evidential value in determining the price at which non-arms length disposals of those grades are taxed. On balance the arrangement would enhance security.

Allowing BP to retain Leg 2(b) oil on the same terms as Leg 2(a) oil raises similar questions to those raised by the Texaco element in the package. However we would propose to continue such an arrangement after the end of the year only if deeper consideration confirms its wisdom and BP still wishes to go down that route. In the short term again the proposal is to our financial advantage.

Thirdly Shell have proposed to increase their liftings from BNOC, but as part of an overall arrangement involving storing oil. The details of this which are set out at Annex II require careful thought. On the whole, while I see some considerable disadvantages in the scheme, I am inclined to think we should allow BNOC to explore the idea with Shell, entirely without commitment, so that the scheme could be put into operation fairly quickly should circumstances ever merit it. We do not have to decide immediately, but I should be grateful for your views.

Failure to pursue the package quickly could lead to companies withdrawing the offers they have already made. Also BNOC needs very quickly to work out with the companies its schedule of disposals in order to avoid demurrage charges (which could be heavy) or being forced to sell distress cargoes spot.

Over the next few days therefore, I, and BNOC where appropriate, will be negotiating the details of these arrangements with the companies concerned. Even if we are successful, BNOC will still have to sell a lot of oil at a loss on the spot market - perhaps over 400,000 b/d.

The costs of this to the country will, however, be very much less than the cost, monetary and political, of a premature price cut by BNOC.

I am sending copies of this letter to the Prime Minister, Geoffrey Howe, Norman Tebbit and Sir Robert Armstrong.

Yours sincerely,

Sandy Buchanan.

ALICK BUCHANAN-SMITH
Approved by the
Minister of State
and signed in his
absence.

ANNEX I

PROPOSED PACKAGE

For the purposes of calculating the likely benefits of the proposals in this package, we have assumed that the measures run for all of August and September and that the spot/term differential remains at $1.50. Cost calculations assume the measures continue until the end of this Quarter and a spot price $1.50 below the BNOC price. The benefits represent savings to BNOC less any consequential tax losses assuming tax at the margin at 75-87.5%.

Esso

Accept reduction of term contract purchases from BNOC including royalty in kind purchases from around 130 kb/d to 85 kb/d. Promise to look again, including taking this up with other Departments, at possible measures to stop oil spinning but ensure Esso are under no illusions as to the difficulties of finding a cure that is not worse than the disease. Net saving to the public sector is $3.2 million.

BP

Accept offer of maintaining RIK purchases of 60 kb/d for remainder of the Quarter. Net benefit $5.5 million. In addition, accept BP's offer to retain the participation Leg 2(b) volumes (55 kb/d) on Leg 2(a) terms for the remainder of the year. This means that BNOC would save a further $5.0 million in the remainder of the Quarter although this would be partly offset by tax losses of $3.8-4.4 million, giving an additional net benefit of $0.6 to 1.2 m. Leave possibility of continuing revised Leg 2(b) arrangements after 1984 for further consideration. (Under BP's participation arrangements, BP currently retains some ¾ of the participation volumes - Leg 2(a) - and has an option to buy back the remainder - Leg 2(b) - at the BNOC price).

Shell

BNOC to pursue with Shell, without commitment, details of the scheme detailed in Annex II with a view to minimising the costs to HMG and possibly reducing/eliminating the storage element. Too early to assess total benefit, but could possibly result in an increase of up to 32.5 kb/d term sales; if there were no storage or other costs, the benefit would be $3.0 million.

Texaco

Offer retention of Getty saleback volumes (35 kb/d) in return for adequate purchases of BNOC oil. Aim to link Getty retention with Texaco maintaining term purchases. Getty retention would by itself give a net benefit to the public sector of $0.4 to 0.8 m. As negotiations have not been held, the likely quantity of additional term sales cannot yet be assessed. We should aim for 30 kb/d for the remainder of the Quarter. This would be worth $2.7 million giving a total benefit of $3.5 million for the whole package. In the longer term, the financial effect of the Getty deal depends on the future relationship between spot, term and tax valuation prices.

Conoco

Press for an increase in their term contract (formerly 45 kb/d) from 15 kb/d to 25 kb/d. If successful, this would save the public sector $0.9 million.

Total

Firm up existing offer of 15 kb/d term purchases from Total (GB) to cover September as well as August and seek a further 5 kb/d term purchases from CFP, the parent company. Saving, if achieved, would be 15 kb/d or $1.4 million.

Mobil

Accept offer to maintain liftings of 15 kb/d at term prices, but firm up price review provision so that retrospective price changes would only occur if the BNOC price was changed during the quarter. Saving would be $1.4 million.

Petrofina

Petrofina has agreed to maintain liftings at 12 kb/d instead of the total phase out it was threatening. It refuses to offer higher liftings. Saving achieved is $1.1 million.

Overall savings from the package range from $15-20 million.

Effects of the Package on BNOC

The change in BNOC's term/spot mix as a result of offers so far made by companies in response to our requests and of the package, if we achieve it, is shown by this table:

	BNOC Disposals				'000 b/d
	Term	%	Spot	%	Total
Position on 1 July	682	77	208	23	890
Threatened position on 1 August	265	29	641	71	906
Position at end August (already) achieved	340	38	566	62	906
Position at end August if package achieved					
(without BP taking Leg 2(b))	462	53	409	47	871
(with BP taking Leg 2(b))	462	57	354	43	816

SHELL'S PROPOSAL FOR REMOVING VOLUMES OF CRUDE FROM THE MARKET

1. Shell have proposed to purchase two tranches of oil from BNOC: 32,500 b/d at full term prices, and a further 32,500 at spot prices. Both tranches would be stored on land at refineries for a period of 60-90 days, effectively removing some 65,000 b/d from the market in an attempt to strengthen the market.

2. The overall effect of the Shell proposal as it stands, is likely to be more costly to BNOC than for the Corporation to continue to undertake spot sales. That is because Shell have asked for a fairly high storage fee - 35¢ bbl - together with extended credit to cover the storage period - an additional 60-90 days credit. Removing 65,000 b/d temporarily from the market is unlikely to have more than a marginal effect in increasing market stability. Indeed, the impact on the market needs careful assessment: volumes of oil in storage appearing to overhang the market could destabilise rather than stabilise it. Furthermore, removing volumes of oil from the market could set an unwelcome precedent, leaving us open to pressure from OPEC countries to repeat the exercise in every subsequent period of weakness.

3. However, it may be possible to amend the proposal so that whether or not the volumes are stored is a matter for Shell's commercial judgement. Then the proposal becomes closer to a straight sale to the company, at a price better than prevailing spot prices, but possibly lower than term prices. If a workable scheme is drawn up, it could be brought into operation quickly; in some circumstances, particularly if the market weakens again, it may be more advantageous for BNOC to implement a revised Shell storage scheme than to continue spot sales. At this stage however, negotiations should continue without commitments.

J254

3.

SECRET COPY NO. 9 OF 12 COPIES

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET

Telephone (Direct dialling) 01-215 5144
GTN 215 .....
(Switchboard) 215 7877

From the Minister for Trade

WBHs

The Rt Hon Peter Walker MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON
SW1

10 August 1984

Dear Peter.

WORLD OIL MARKET

I have seen a copy of your letter of 30 July to Nigel Lawson, and Nigel's reply of 3 August.

I am not entirely convinced that there would be a net cost to the country if oil prices were to fall, although I recognise of course that a sharp and sudden reduction might have disruptive effects in the short term.

I do however fully share your concern that if a fall were to take place the UK should not be seen to be in the lead. If a fall is inevitable, we clearly should do everything we reasonably can to avoid damaging our trading relations with OPEC producers and our investments in these countries. Nigeria in particular could be very unforgiving - even to the point of retaliatory action against our commercial interests - if they thought that the UK had had a hand in bringing about lower oil prices. Given ECGD's exposure in the market, this is a risk we should take care to avoid.

I am copying this letter to the recipients of yours.

Yours,

PAUL CHANNON

SECRET

SECRET

Z

NBPM CCNO AT 3/8

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

3 August 1984

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Thames House South
Millbank
LONDON SW1P 4QJ

Dear Secretary of State,

WORLD OIL MARKET

Thank you for your letter of 30 July.

I agree that unless the present market weakness is short-lived it will be very difficult to hold BNOC's prices for long. We would, I believe, need to weigh carefully the likely costs of trying to do so. In particular the potential longer-term consequences of the possible "inducements" to BNOC's customers you mention in your letter will require close consideration. It would also seriously compromise the policy we have pursued if we were to take measures on production or oil supply to try to influence prices. I am sure you will have these considerations very much in mind when putting forward any proposals.

I am sending copies of this letter to the Prime Minister, Geoffrey Howe, Norman Tebbit and Sir Robert Armstrong.

Yours sincerely

David Peretz

NIGEL LAWSON
[Approved by the Chancellor, and signed in his absence]

ENERGY : Oil Prices : Per

Prime Minister (2)

Policy Unit are quietly saying "I told you so" over decision not to wind up BNOC. It is probably too soon to reopen this now but agree questions be asked when current phase of weakness is over?

AT 1/8

CONFIDENTIAL

I assume SofS is in touch with Sheik Yamani? MT

Yes MT

MR TURNBULL

1 August 1984

THE OIL PRICE

The oil market is extremely weak and talk of crisis abounds. Spot prices of North Sea oil are now about $3.60 below BNOC's term prices and have fallen rapidly during the last two weeks. The Arabian Light marker crude is $2 below the official price.

BNOC are now having to dispose of 340,000 barrels per day onto the spot market at a daily loss of $1.2 million. Not surprisingly, the BNOC price is under extreme pressure.

How did we get here?

The market had always anticipated that the second quarter would be extremely difficult but that the situation would then become easier as demand picked up. However, the Iran/Iraq war more than compensated for any underlying weakness during the second quarter. Demand was also stronger as many companies built up stocks earlier than anticipated.

As a result the underlying weaknesses in the market were transferred into the third quarter although both OPEC and many market traders had assumed that the worst was over. The impact of the Iran/Iraq war has also been largely discounted and the market believes that supply interruptions are unlikely.

Discounting and over production remain major problems for OPEC. Production was probably running at about 18.5 million barrels per day (mbd) during June and about 18 mbd during July. This compares with the official quota of 17.5 mbd.

Iran has been able to use the excuse of war risk discounts and has effectively cut its price by about $2.50 a barrel. It is ironic that Nigeria, with probably the most severe economic problems, has largely remained true to official prices. As a result, they are not producing at their quota levels and are unlikely to do so without hefty discounts on a crude which competes directly with the North Sea.

The situation has not been helped by Saudi Arabia's oil-for-aircraft barter deal with Boeing and Rolls Royce. This is believed to involve 36 million barrels of crude oil which is coming onto the market during July and August. Consequently the market has had to absorb an extra 1 mbd at the height of Summer.

DAWAAT

CONFIDENTIAL

This deal is also worrying on two further counts. It is the first time that the Saudis have adopted a barter approach which is almost certainly disguising some hidden discounting on the official oil price. It also appears to have taken place against the advice of Sheikh Yamani although there is no other reason to believe that Yamani's voice is not as influential as ever within the Royal Family.

The Prospects

It is still likely that demand will increase as we move into the fourth quarter. Although the confidence which OPEC displayed in Vienna in early July that output would rise to 19 mbd later in the year now looks misplaced, the current quota of 17.5 mbd and the marker price of $29 per barrel do look sustainable for the longer term. The stability of the oil market will therefore continue to depend upon the discipline within OPEC and in particular upon the role of Saudi Arabia, and on the state of the conflict between Iran and Iraq.

Sheikh Yamani has indicated privately that Saudi Arabia will act to reduce its own production and thereby restore confidence in the market.

The BNOC price

Once again BNOC has been placed in a totally inappropriate price leadership role with no room for manoeuvre. We cannot be seen to lead the world oil market down and we are therefore forced to defend a politically exposed BNOC price.

Meanwhile, the corporation is making heavy losses, the Inland Revenue are unable to use the BNOC price as a defensible tax reference price, and we are having to lean on the oil companies to accept a price which is not market determined. It is by no means certain that the companies will accept this pressure even with some of the inducements which Peter Walker is offering.

We continue to believe that the only long-term solution to these problems is the abolition of BNOC. As long as BNOC exists, we shall continue to come under the diplomatic spot light every time there is a weakness in the market. Without it, the market could smoothly adjust to changing conditions, as the US market does, without the Government ever being involved and without world oil stability being threatened.

In the meantime we have no alternative but to attempt to sustain the BNOC price for a limited period while we see

whether Saudi Arabia can reimpose discipline within OPEC. A collapsing oil market is in nobody's interest but it would be costly and probably ineffective for the UK to attempt to bolster the international oil price for an extended period. Furthermore, if BNOC did reduce its price now it would be extremely difficult to restore it in the fourth quarter when market conditions are firmer.

We should continue to avoid any suggestion of cutting UK production levels. If the position does not improve, we could consider our own limited forms of discounting, but in the end we shall have no alternative but to cut the price.

Conclusion

The key to the current weakness in the oil market lies with Saudi Arabia. If they reduce production and restore market confidence, the current official prices are sustainable through the fourth quarter and into next year.

In the meantime, we have no alternative but to support the current BNOC price of $30 per barrel, despite the losses which we are incurring and the pressures which we are having to put upon the oil companies.

This position is sustainable only for a strictly limited period, while Saudi Arabia is given a chance to restore market stability. If this does not happen, current BNOC losses are unacceptable. There is perhaps some limited scope for discounting but eventually we must reduce the price.

In the longer term we must reduce the political exposure of the BNOC price, preferably through the abolition of BNOC when market conditions allow.

DLP.

DAVID PASCALL

DAWAAT

SECRET

Copy No 2 of 6

Prime Minister (2)

To note. Pity we did not get rid of BNOC when it was losing money and dragging HMG into the forefront of the oil market

AT 31/7

01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

30? July 1984

WORLD OIL MARKET

The consequences of OPEC's excess production in May and June are now hitting the oil market hard. Spot prices of North Sea oil are about $3 below BNOC's term prices. There have been some, so far, minor cuts in US posted prices. The USSR has cut its prices by $1.45 a barrel.

BNOC lost 60,000 b/d of its term custom earlier in July and is now selling on the spot market 340,000 b/d out of its total freely disposable avails of 870,000 b/d. At that rate, it is losing $1.2 m per day. Many of its remaining customers have threatened to start the phase out process from 1 August. Not surprisingly, Douglas Croham and Ian Goskirk came to see me on Thursday to propose a reduction in BNOC's term prices of $3 per barrel.

We continue to believe that the current surplus of crude oil on the market is temporary, and that spot prices should strengthen as seasonal demand increases next quarter providing OPEC members stick to their production ceilings. Prices will only harden when the market perceives that supply has been brought down into line with demand. In such a situation a price cut by BNOC would merely lead the market down without much likelihood that it could be restored as the market stengthened. Indeed, even at lower prices, BNOC may be unable to retain many of those term sales which are at risk.

If a price cut does become inevitable, it is important that we should be seen to have followed, not led other producer countries. The cuts in posted prices so far have not been of enough weight to convince OPEC that a cut in BNOC prices would be following the market.

I have accordingly asked BNOC not to propose any reduction in prices. Yamani has contacted me, and has asked for a private meeting tomorrow at my house. This I have agreed to do. I intend to impress upon him the seriousness of the situation and the need for Saudi Arabia to fulfil its role as swing producer and to cut its production, which has been high in recent months. I and my officials are offering every encouragement to BNOC's remaining term customers to continue to purchase from BNOC at current prices. It may be necessary to offer some inducement to obtain these results (about which my officials will consult yours).

SECRET

The costs of such inducements will be very much less than the costs to the country of a fall in oil prices.

There remains a serious risk that a price cut will become unavoidable. I shall keep you in touch with the situation.

My officials have already been in touch with yours about the financial implications of BNOC maintaining its present prices.

I am sending copies of this letter to the Prime Minister, Geoffrey Howe, Norman Tebbit and Sir Robert Armstrong.

PETER WALKER

OIL : ADVANCE COPIES (32) (32)

PS No. 10 DOWNING ST.

PS
PS/MR WHITNEY

PS/PUS
SIR C TICKELL
MR [illegible] GOODALL
MR [illegible] O'NEILL
MR J THOMAS
MR [illegible]
ED/[illegible]
ED/[illegible]
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ED/[illegible]
ED/[illegible]
RESIDENT CLERK

MR [illegible]
MR WIGGINS
MR HIGSON
MR [illegible]
MISS [illegible] BOYS
MS CAMERON
PS/ S of S for ENERGY
} DEPT OF ENERGY THAMES HS SOUTH

MR B UNWIN
MR P LAVELLE
MR N WICKS
MISS ME CUND
} FM TREASURY

MR P MARTIN FM 116
MISS LACKEY WEG
MR D FORD OT5
} DOT 1 Victoria

MR GRAHAM HARRISON) CDA

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UNCLASSIFIED
DESKBY 110900Z
FM VIENNA 101615Z JUL 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 53 OF 10 JULY
INFO PRIORITY DEPT OF ENERGY, TREASURY, OECD PARIS

OPEC MINISTERIAL MEETING, VIENNA, 10 JULY

1. THE MINISTERIAL MEETING WAS PRECEEDED BY A MEETING OF THE OPEC MONITORING COMMITTEE ON 9 JULY WHICH RECOGNISED THAT THE WORLD OIL MARKET IS STILL WEAK AND OVER-SUPPLIED AND RECOMMENDED THE MAINTENANCE OF THE EXISTING OPEC PRODUCTION CEILING OF 17.5 MILLION BARRELS PER DAY AND THE PRESENT PRICE OF 29 DOLLARS PER BARREL FOR MARKER CRUDE. THE MONITORING COMMITTEE'S CHAIRMAN, OTAIBA, CLAIMED THAT THERE WAS NO PRESSURE FROM MEMBER COUNNTRIES, INCLUDING NIGERIA, FOR INCREASED INDIVIDUAL QUOTAS.

2. THE MINISTERIAL MEETING IS STILL IN PROGRESS AND IS EXPECTED

2. THE MINISTERIAL MEETING IS STILL IN PROGRESS AND IS EXPECTED TO CONTINUE UNTIL 11 JULY. IN HIS OPENING SPEECH, THE RE-ELECTED PRESIDENT, MAGHUR OF LIBYA, CLAIMED THAT THE DISCIPLINE SHOWN BY OPEC MEMBERS IN CONTROLLING DISCIPLINE WAS RESPONSIBLE FOR THE PRESENT REASONABLY STABLE MARKET CONDITIONS IN THE FACE OF WEAK DEMAND AND OVER SUPPLY. NON-OPEC PRODUCERS (BRITAIN AND NORWAY WERE MENTIONED SPECIFICALLY) WERE CRITICISED FOR LACK OF RESTRAINT IN PRODUCTION AND ACCUSED OF OVER SUPPLYING AND DE-STABILISING THE MARKET. ANOTHER FACTOR HAD BEEN DE-STOCKING BY INDUSTRIALISED COUNTRIES. MEXICO, ON THE OTHER HAND, WAS PRAISED AS A NON-OPEC MEMBER WHICH HAD EXERCISED RESTRIANT IN PRODUCTION. MAGHUR APPEALED FOR CLOSER CO-OPERATION BETWEEN OPEC AND NON-OPEC PRODUCERS IN THE FUTURE.

3. THERE HAVE BEEN NO FORMAL STATEMENTS BY DELEGATES SINCE THE CONFERENCE COMMENCED BUT OFF-THE-CUFF COMMENTS INDICATE THAT THE GENERAL FEELING IS THAT THERE IS LITTLE CHANCE FOR OPEC BUT TO CONTINUE TO EXERCISE RESTRAINT AND THAT CHANGES, EITHER IN OVERALL AND INDIVIDUAL PRODUCTION QUOTAS OR IN PRICE, ARE UNLIKELY.

4. FURTHER REPORT TO FOLLOW.

ALEXANDER

NNNN

SENT AT 10/1647Z DP KK

RECD AT 10/1652Z JW

CC DP

Prime Minister (2)

AT 13/6

01 211 6402

Miss Margaret O'Mara
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

13 June 1984

Dear Margaret,

THIRD QUARTER OIL PRICES

In spite of the tension in the Gulf and the extra oil demand created by our coal strike, spot prices have remained on balance below term prices in the past few months. There is no clear evidence that demand for oil will be higher in the coming quarter: on the other hand Nigeria is under very strong financial pressure to increase its production. BNOC has contractually to make firm proposals tomorrow to its suppliers and customers: the market situation is such that it intends to propose no general change.

It is however proposing two minor adjustments. One of these, a 10 ¢ increase in the price of Maureen crude, is justified by the relative strength of demand for that curde. The other, a 15 ¢ increase in the price of Ninian blend, may well not be accepted by BNOC's customers. But BNOC has to propose it in order to protect itself against the likelihood that it would be taken to arbitration if it proposed any lower price.

My Secretary of State intends to let BNOC know by noon on 14 June that he does not propose to intervene.

I am sending copies of this letter to Andrew Turnbull (No 10), Roger Bone (FCO) and Andrew Lansley (DTI).

Yours
John

J S NEILSON
Private SEcretary

CONFIDENTIAL

Prime Minister (2)

To note X and Y in particular AT 1/6

CONFIDENTIAL

MR TURNBULL

1 June 1984

THE OIL MARKET

Following John's note about banking and oil, I thought you should be brought up to date on the Gulf's impact on oil prices and supplies. So far the Gulf is still functioning quite well and there is no panic in oil markets.

Spot Prices

North Sea spot prices are at term levels while the Arabian light OPEC marker crude is trading at 50 cents per barrel below official prices. Although the increased tension in the Gulf has resulted in firmer prices than would otherwise have been the case, the market generally remains calm. Indeed, without the recent events in the Gulf we would be worrying about a potential price collapse.

Although the spot price would undoubtedly increase rapidly if the Straits of Hormuz were closed, the level and duration of the rise would depend on attutudes towards stocks and supplies. These perceptions will be conditioned by the initial reactions of governments, the IEA, other producing countries and the perceived willingness of consuming countries to draw on stocks. Provided that there are clear, immediate and credible statements of intent by all these parties, a closure of the Straits for even six months would be manageable.

The general feeling is that the Straits would only be closed for a short period of time. The market is generally reassured by the statements from President Reagan and is comforted by the 55-60 million barrels of oil which Saudi Arabia has in floating storage outside the Gulf.

Stocks

The trade figures for April do indicate a 5% increase in total UK stocks. On a wider scale, stock build-up in the IEA in April amounted to about 1%. However, the overall impression, confirmed by informal discussions with oil companies, is that the general approach is to refrain from reducing stocks further rather than a general policy to build up stocks. The companies have spent the last three years running down stocks in order to produce a better working capital position and they are reluctant to reverse this trend, except in response to events rather than expectations. Closure of the Straits of Hormuz has been billed many times before. The companies have made their contingency plans and remain generally relaxed.

Nevertheless, they are tending to buy further forward

DATAAD

than normal with the emphasis on more secure sources of supply. However, this is only occurring for July oil and no company appears to be buying forward into August or September.

Traffic in the Gulf

There are conflicting reports about the extent to which the flow of tankers through the Gulf has been disrupted by recent events. Despite press reports that traffic is nearly at a standstill, information provided by posts and the companies seems to indicate that at a maximum traffic has been reduced by perhaps 20%. It is quite normal for there to be 30 tankers waiting outside the Gulf and press reports that this indicates an unwillingness to venture into the Gulf are misleading. The main problem is still in the north of the Gulf and tankers are moving quite freely in the south.

However, loadings at Kharg Island are significantly down. Estimates vary widely but the general impression is that between half to one million barrels per day were loaded last week compared with a normal level of 1.6 million barrels per day.

Conflicting information is also being received about loadings at Kuwait. Some posts indicate that these are proceeding normally whereas some company information indicates that loadings are perhaps down by as much as 50%. However, this is blamed more on insurance rates than on the risk of physical attack.

Fuel Oil Supplies

Oil burn is a vital part of the CEGB's endurance strategy. However, we would not expect the closure of the Straits of Hormuz to threaten this policy.

Current fuel oil supplies are split a third directly from neighbouring refineries, a third from term contracts and a third from the spot market. The oil companies have undertaken to continue direct and term deliveries on a "best endeavours" basis at Platts (market) related prices.

It will be important that the CEGB are in a position, if necessary, to withdraw from the spot market in the critical weeks following any closure of the Straits. In this context, they have now recently started buying forward on the spot market by 4-6 weeks on a fixed price basis - a very welcome development in view of the uncertainties. They are reluctant to become further exposed in terms of forward commitments, particularly in view of the uncertain duration of the miners' strike.

DATAAD

The Board are also holding maximum oil stocks equivalent to about 2 weeks of total oil burn (ie nearer 6 weeks of spot purchases).

These two factors provide flexibility for the CEGB to withdraw from the spot market. If prices did remain high for an extended period the Government could allow the Board to draw on UK company stocks which could meet CEGB demand for 20 weeks.

This assumes that all fuel oil strategic stocks are allocated to the CEGB which could bring us under pressure both from other UK industry and internationally to reduce oil burn.

If the situation did become critical, we could always take wide-ranging powers under the Energy Act, 1976 to regulate supplies within the UK.

Conclusions

The oil market remains calm and there are no signs of panic. Spot prices are not above term prices. There is a modest build-up in stocks and an increasing tendency to buy further forward.

Closer examination of the situation in the Gulf supports the generally relaxed attitude being taken by the companies. Traffic through the Gulf appears not to be significantly reduced although loadings at Kharg Island are down. Providing the damage can be confined to the northern war zone the oil market reaction is the correct one.

If the Straits were closed, the immediate reaction of all parties concerned will be crucial in ensuring that price and the supply remains under control. Perceptions rather than realities will be determining. Although the spot price will undoubtedly jump if a crisis occurs, a prompt and credible response could limit the price and supply difficulties.

It is encouraging that very recent purchases of oil by the CEGB now gives them at least 2 months' endurance with maximum oil burn without any further purchases. All the time that tension in the Gulf remains, they should preserve a satisfactory stock and forward oil position.

DLP.

DAVID PASCALL

DATAAD

NBPM AT6/2 cc NO

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5422
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(Switchboard) 215 7877

JU597

Secretary of State for Trade and Industry

CONFIDENTIAL

6 February 1984

The Rt Hon Sir Geoffrey Howe QC
Secretary of State for Foreign
and Commonwealth Affairs
Foreign & Commonwealth Office
Downing Street
SW1

D Geoffrey

PROSPECTS FOR THE WORLD OIL MARKET

I have seen Peter Walker's letter of 20 January and the subsequent minutes from you and Nigel Lawson.

I share the view that taking radical measures to affect the balance of supply and demand for oil is most unlikely to be justified. I am of course conscious that the interests of industrial and domestic oil consumers might best be served by a fall in the crude oil price. Our commitment to price stability is based on the extreme difficulty in current circumstances of engineering the modest and gentle fall which might be in our overall economic interests.

Because of the disruptive effects of a sudden fall, however, I agree that we should be prepared to consider some of the tactical measures described in the paper if the need arises. Here of course the case for taking action would be considerably strengthened by the presentational impact of our policies on safeguarding our commercial and financial interests in OPEC countries, to which you have referred.

I am copying this to the Prime Minister, Nigel Lawson and Peter Walker.

Yours Norman

NORMAN TEBBIT

Energy : Oil Prices Pt 2

10 DOWNING STREET

Prime Minister (2)

To note the reactions of the Foreign Secretary and Chancellor to the Walker's paper

AT
26/1

CONFIDENTIAL

CC(NO

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

FOREIGN AND COMMONWEALTH SECRETARY

OIL

I read with interest Peter Walker's letter of 20 January and the paper he enclosed on the prospects for the world oil market. I have also seen your minute of 25 January.

2. The situation is not unlike this time last year, and should I believe be approached, as Peter suggests, in much the same way as it was then. The oil market remains fragile, but on balance it looks probable that the current nominal dollar price might be maintained through 1984, although we may well face a very tricky period in the second and third quarters. We may therefore need to consider from time to time the tactical measures described in the paper. Their deployment would depend on an assessment of their cost and effectiveness in the precise circumstances, and market conditions, at the time.

3. As for measures which affect the balance of supply and demand, Peter outlines the difficulties they would involve, and I fully agree with him. I find it hard to envisage circumstances in which it would be sensible to use them.

Copies of this minute go to the Prime Minister, Peter Walker and Norman Tebbit.

N.L.

26 January 1984

Energy: World Oil Market pt. 2

CC, NO.

FCS/84/22

SECRETARY OF STATE FOR ENERGY

Prospects for World Oil Market

1. Thank you for your letter of 20 January.

2. I agree with the analysis of oil market prospects in the paper you enclose, and with the conclusions set out in paragraph 11.

3. Our commercial and financial interests in some OPEC countries - notably Saudi Arabia and Nigeria - are very large, and the fact that BNOC is not an agent of the British Government is not always understood fully. If the prospect of a price collapse does emerge, it will be important to avoid the impression that BNOC are undermining the stability of the market. In these circumstances, the tactical options you list may well prove useful.

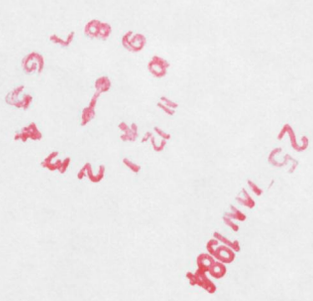
4. I agree that we should not contemplate direct measures to control UK output except, perhaps, in very special circumstances such as those described in the paper.

5. I am sending copies of this minute to the Prime Minister, the Chancellor of the Exchequer, and the Secretary of State for Trade and Industry.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
25 January 1984

ENERGY: OIL PRICES: Pt 2



MR TURNBULL

20 January 1984

PROSPECTS FOR THE WORLD OIL MARKET

We agree that there is a reasonable chance that the world oil market price can be maintained in nominal dollar terms for the coming year although the general prospects remain fragile.

Peter Walker identifies certain tactical options which could help maintain stability. These all involve some cost and should only be considered if major difficulties emerge.

We agree that the UK should not attempt to influence the balance of supply and demand through the control of UK production. As Peter Walker points out, unilateral action by the UK would not work, and would damage confidence in our policy of relying on market forces for the optimal development of the North Sea. We are also doubtful that even a co-ordinated response with OPEC would be effective.

With the recent cold spell in the USA and general concerns about the Iran-Iraq war, spot prices are now only about 20-60c/barrel below the marker prices. OPEC production is perhaps 0.5 mbd above the production ceiling of 17.5 mbd and the general trend is downwards. All of these factors are encouraging. However, considerable uncertainties remain.

The early statements by the new Nigerian Government are reassuring but the pressures on them and the other high absorbers in OPEC to raise revenue are considerable.

There is considerable uncertainty about the likely course of the Iran-Iraq war with the possibility of significant developments in the coming months.

The behaviour of Saudi Arabia is also puzzling. They appear committed to maintaining the OPEC marker price but are currently producing more than they are selling. The excess is being stored in tankers especially chartered for this purpose. The Saudis now have perhaps 50 million barrels of oil in floating storage to the value of $1.5 billion.

The reasons are unclear. Three possible explanations are

- an ability to exert pressure on the other members of OPEC by threats to flood the market

- build up of stocks to cover a shortfall in production as new gas lines are tied in - ie a technical explanation

- concern that a flare-up in the Iran-Iraq war will close the Straits of Hormuz.

As the Saudis now appear to have greater volumes afloat than would be necessary for the first two explanations, the third reason is perhaps the most plausible. Whatever happens, at some stage this oil will have to be sold in the market.

In terms of prospects for this year, the greater pressure is likely to occur during the 2nd quarter - assuming no major developments in the Iran-Iraq war. This is also the time when demand is likely to be weakest as the Winter ends and before the effects of world economic recovery are felt in the market.

Although 1984 will therefore be a difficult time in the oil market and the outlook remains uncertain, there is a fair chance that a major destabilising crisis can be avoided.

DLP.

DAVID PASCALL

CONFIDENTIAL

CC NO

Prime Minister (2)

To note. Mr Walker is not proposing action on any of the options at present. PU note also attached conclusions at para 11.

AT 20/1

01 211 6402

MG

The Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign &
Commonwealth Affairs
Foreign & Commonwealth Office
Downing Street
LONDON
SW1A 2AL

20 January 1984

PROSPECTS FOR THE WORLD OIL MARKET

We corresponded on this last November. I now attach a paper by officials.

The paper warns that, while the current world oil market price can probably be maintained in nominal dollar terms for the coming year, there nevertheless remains a significant risk of a price collapse. Such a risk would continue beyond next year.

It was agreed last spring that a precipitate decline in the price of oil was undesirable. But the UK is is no position independently to maintain a particular term price for UKCS crudes irrespective of market conditions. The most we can and ought to do is encourage stability.

The paper identifies certain tactical options which could help maintain stability, or at least avoid the appearance of initiating a fall in prices. All involve some cost. The case for pursuing them, however, is reinforced by the risks to UK interests if we were thought by OPEC countries to be undermining the stability of the oil market. The cost and effectiveness of such options depend on the circumstances at the time they might be employed.

To go beyond these and to attempt to influence the balance of supply and demand through the control of UK output would be very costly. It could damage confidence in North Sea investment, and would represent a major change in our depletion policy. In any case unilateral action by the UK would not work. I recommend against such an approach unless it appears that it is the only way of clinching an OPEC production agreement at a time of collapsing prices where the potential damage to the UK economy outweighs the disadvantages. Such a combination of circumstances appears very unlikely.

I am sending copies of this letter to the Prime Minister, Nigel Lawson and Norman Tebbit.

PETER WALKER

PROSPECTS FOR WORLD OIL MARKET

Report by Officials

BACKGROUND

1. In November and December the oil market weakened significantly, partly because of an over optimistic assessment in the third quarter of prospective demand leading to over-production by OPEC and particularly by Saudi Arabia. There has been discounting by certain OPEC countries. Spot prices in the US and international markets fell to more than $1.50 below term for North Sea qualities. OPEC Ministers met in Geneva from 5-7 December. They reaffirmed their commitment to the March 1983 "London agreement" to a marker price of $29 (Saudi Light) and production ceilings aggregating to 17.5 m barrels a day (m b/d). To avoid undermining the market BNOC subsequently proposed no change in its prices (based on $30 for Brent blend) for the first quarter of 1984. There was little initial reaction in the spot market either to the OPEC meeting or to BNOC's proposal. However the subsequent very cold weather in the USA, helped perhaps by statements of commitment to the London agreement by some OPEC states, in particular Iran, have since raised spot prices by around $1 a barrel. BNOC has lost only a little of its term custom; we have heard that Statoil and Britoil have also lost some.

2. If the rest of this winter in the main consuming countries is average and the oil industry follows historic patterns of destocking, demand for OPEC oil will stay comfortably above the current OPEC ceiling in the first quarter of 1984 but decline marginally below it in the second. In that case, the current marker price for term oil should hold though real prices may decline slightly either through general inflation or as a result of a decline in the relative value of the dollar or because of an increase in the proportion of sales made at discounts or lower spot prices. In the second half of 1984, demand should exceed the ceiling by a million or more b/d.

However a mild winter from now on or a collapse of market confidence in OPEC's determination to stick to its agreement could lead to a significantly greater stockdraw reducing demand for OPEC oil to or even below 16 m b/d in the second quarter of 1984; problems could arise as early as the first quarter. Such a drop in demand would pose serious difficulties for OPEC. Destocking could not reach the scale or duration which it reached in the spring of last year; but it could still put BNOC under very strong pressure to reduce prices in order to retain term customers. While the new Government in Nigeria has affirmed its commitment to OPEC and, apparently, to the agreed prices and production quota, we must expect it, like its predecessor, at least to threaten to match any drop in BNOC prices: indeed it may yet decide that the only way out of Nigeria's financial difficulties is to expand oil sales by initiating price cuts. Market pressures could thus give rise to a situation similar to that experienced in the first quarter of last year. Once a downward movement in prices was initiated, there would be no obvious stopping point - restoration of stability would again depend on OPEC coming to an agreement among themselves.

3. Accordingly, while the balance of probabilities remains that the current marker price will be retained in nominal dollar terms for the coming year, there is a significant chance of a price collapse.

4. The fundamental tensions will remain in the market even after the first half of 1984. There are no signs that OPEC's spare capacity (currently 10 m b/d against production of 17.5 m b/d) will diminish to comfortable levels within the foreseeable future. The high absorbers in OPEC will remain anxious and able to expand production to finance their development schemes. If the Iran-Iraq war ends Iraq in particular will be desperate to produce oil as fast as possible to re-establish economic strength although the

build up of production may take some time. An excess of demand for OPEC oil over the current production ceiling need not strengthen the market; indeed the immediate effect may be to encourage irreconcilable claims to that excess or price competition between OPEC countries to win that additional custom. The risk, therefore, of a fall in the price of oil will remain for some years. That fall could be considerable - to $20 a barrel if at that point the US were willing to substitute enough oil for coal in its electricity system; well below that if the floor were set by the marginal cost of meeting the current demand for oil. However so long as some production is required from the Gulf to meet current demand, such a reduction in price would be unlikely to persist unless that were the wish of Saudi Arabia and its Gulf allies.

HMG'S POLICIES

5. Ministers decided, following the $5 reduction in OPEC's marker price last spring that a precipitate decline in the price of oil was undesirable. While the UK would benefit, at least for a time from increased output and perhaps lower inflation, there would be immediate disadvantages from loss of tax revenues and the possible effect on the exchange rate; moreover there might be problems resulting from increased turbulence in world financial markets. The loss of tax revenue if the oil price fell to $25 per barrel would be £1.5 bn in the first year. However, a small fall in the nominal oil price that did not lead to a collapse in price, might well not be unwelcome. But in present circumstances even a small price reduction by one or more producers would almost certainly be trumped by further and larger reductions by others. (Only Saudi Arabia with its ability to expand or cut back production significantly may be able to engineer a controlled reduction; there is no evidence that it currently wishes to do this.) Ministers therefore agreed last spring that the UK's objective for the time being should be to avoid taking the lead in undermining the prices for oil which had emerged from the OPEC meeting in March. The analysis underlying that decision still holds.

6. It remains Government policy that the price and level of production of North Sea oil should broadly be determined by the market. We are in no position independently to maintain a particular term price for UKCS irrespective of market conditions. The most that the UK can and ought to do is encourage stability. The case for doing this is reinforced by the risks to UK interests and investment if we were thought by OPEC to be undermining that stability; several OPEC countries (notably Saudi Arabia and Nigeria) are very important export markets for the UK,* and much of their import trade is regulated by contracts either directly or indirectly in the hands of the local Government and thus exposed to interference by that Government.

THE UK POSITION IN THE WORLD OIL MARKET

7. The UK is only a medium-sized producer and one which - in sharp contrast to the OPEC countries - has no centralised commercial control over production such as exists where decisions are all in the hands of a monopoly state oil company. The overhang of OPEC surplus capacity disproportionately exceeds any production cut we could make, and any unilateral move by the UK risks simply transferring benefit to OPEC countries without any change in the underlying market situation. In the end the threat to stability comes from OPEC not setting and observing a sufficiently restrictive set of production ceilings to enforce whatever price level is agreed. The UK - which runs a free market in oil - has necessarily stood aside from taking responsibility for price-fixing, which depends in the end on the Gulf producers who have the financial resources and volume of reserves necessary to take a long view. OPEC might no doubt like us to share with them the burden of production restraint, and might argue that unless we (and USSR and Norway) did this, prices would fall very sharply to our detriment. But there is a large element of bluff in this. OPEC has to defend its

* British commercial interests in Nigeria are greater than anyone else's - investment of about £2 bn, exports in 1983 worth about £750 m and total ECGD exposure of about £4 bn debt with payments of at least £750 m due or overdue in 1984.

prices whether we help them or not. And Saudi Arabia in particular appreciates that we cannot part company with the US and European Community in order to join an oil cartel of developing countries whose cohesion and behaviour are doubtfully reliable.

POSSIBLE MEASURES

8. It is clear from the position of the UK in the world oil market that the scope for UK initiatives designed to affect the world price of oil will inevitably be very limited. Measures which the UK could take to help maintain nominal prices or at least avoid appearing to precipitate a collapse fall into two groups:

(i) tactical measures on pricing and taxation which do not affect the balance of supply and demand but could persuade companies to continue for the time being to take oil from BNOC at a declared price of $30;

(ii) measures which directly affect supply or demand.

TACTICAL MEASURES

9. Annex I lists possible tactical measures. All have varying disadvantages. The measures to be used, if any, will need to be determined from day to day in the light of their costs, effectiveness and transparency which cannot be foreseen in advance. All are likely to increase the PSBR both directly through effects on BNOC's finances and indirectly through their effect on valuation of oil not sold at arms-length; but in practice these losses would be incurred to avoid larger losses in tax revenue from a collapse in prices.

MEASURES WHICH WOULD DIRECTLY AFFECT SUPPLY AND DEMAND

10. Annex II lists possible measures which the UK could take. Measures to increase stocks, or restrict North Sea out would be expensive. Unilateral action by the UK would have little effect on the balance of supply and demand though the change of policy it would represent could affect market sentiment. Any cut in UK production would be swamped by a small variation in the strictness

with which OPEC observed its own quota. A cut in UKCS production would only be effective in stabilising prices if it were itself the necessary and sufficient condition for the achievement of an OPEC agreement which thereafter was generally respected. Even then, the damage to the UK economy, both immediately and in its impact on the confidence needed for the continued development of high cost UK petroleum reserves could prove considerable; and once the UK had entered into mutual commitments with OPEC, it would be very difficult to disengage.

CONCLUSION

11. We therefore conclude:

(i) the balance of probability is that the marker price will be retained in nominal dollar terms for the coming year but there is a significant risk of a price collapse;

(ii) unilateral cuts in production by the UK would have little effect on the world balance of supply and demand (although they might affect market sentiment) but they would represent a major change in the Government's depletion policy which would damage the confidence of UK industry in North Sea development and would be costly;

(iii) to be effective any cuts in UKCS production would need to be co-ordinated with other producers, especially OPEC. This would entail a major re-adjustment of our traditional stance as a firm OECD/EC member and a "free market" producer;

(iv) such cuts would be worth considering only if they might clinch an OPEC production agreement at a time of collapsing prices in circumstances where the potential damage to the UK (and world) economy,

including the effects on our trade with and investment in OPEC countries, outweighed the domestic economic and political consequences of production cuts. Such circumstances appear unlikely;

(v) should major difficulties emerge consideration should be given in the first instance to the tactical measures in Annex I in order to persuade companies to take oil from BNOC at a declared price of $30, thus avoiding the appearance of initiating a fall in prices.

ANNEX I

TACTICAL MEASURES ON PRICES AND TAXATION

(i) Selective Discounts on Official Price. Probably more costly to BNOC than spot sales because they are likely to extend beyond the period of immediate market weakness. Discriminatory. If it became known would affect long term credibility of BNOC and HMG and attract OPEC reaction. Used in 1982.

(ii) Extended Credit. Would attract imitation from other producers but less politically sensitive than a price cut. BNOC would bear the extra credit cost. Would not help saleback customers.

(iii) Inclusion of Freight Costs within the Declared Price. Effect similar to that of discounts. In addition BNOC's chartering of tankers would be known and therefore the measures would be more transparent.

(iv) Saleback Based on UK Refinery Netback. Similar to OPEC practice and therefore less likely to attract reaction from them. Since it would have to be confined to UK refiners, it would probably breach the Treaty of Rome but might not become known. Calculation of the price would be complex and disputatious.

(v) Rearranging Differentials. By varying the discounts or premiums at which other UKCS crudes are sold relative to Brent blend, the UK marker crude. This trick was used last spring. Probably less scope second time round.

(vi) Backdating Prices. May be essential to allow time for market to clarify itself and OPEC to reorganise. This measure was also used last spring.

(vii) Changing the Taxation System. Modifying the system of valuation or other changes to the taxation system would require legislation and possible changes to BNOC's role. Such changes are currently being assessed in the BNOC Review; it is unlikely that changes could be made quickly and flexibly enough to affect the outcome of a crisis in the oil market.

ANNEX II

MEASURES WHICH WOULD DIRECTLY AFFECT SUPPLY AND DEMAND

(a) Increase Obligatory Stocks

1. HMG could directly increase world demand for internationally traded oil by increasing the UK's statutory stocking requirements and encouraging its European partners to do likewise. A report has recently been made to the Commission recommending an increase in strategic stocks. The UK has so far opposed its implementation. Even if the UK were to change its line, agreement could not be reached and a direction approved in time for the consequential stockbuild to affect demand in the first half of this year slthough widespread EEC support for such a measure might have a limited effect on market sentiment. Similar the statutory requirements for raising obligatory stocking levels in this country require procedures too lengthy to affect demand in that period. The oil industry would strongly resist such increases. An increase of 10 days in EEC stocks would raise crude oil demand over the year by 250,000 b/d at a capital cost of $2.7 bn and annual storage costs of $585 m (UK's share: $480 m and $100 m a year, respectively

(b) Hold Oil off the Market

2. The UK could reduce the amount of UKCS oil reaching the market, without affecting production levels, by storage. That would require tankers to be hired to take the oil. The costs of hiring tankers to take off the market 100,000 b/d for 3 months and store it for a further 3 months would be $4 m. The financing of such storage would have to be undertaken by the public sector - revenue would of course be deferred and the oil might well in due course have to be sold at a loss. The operation would be highly visible and thus itself pose a threat to the stability of the market.

(c) Restrict UKCS Production

3. The Government has powers applicable to all licensees, to cut production. Fields now produce either under consents normally given every 3 or 6 months or in accordance with production programmes

approved by the Secretary of State for Energy. As regards the former, it would be possible for HMG to renew consents at reduced levels of production; as to the latter the licensing arrangements include procedures under which production can be constrained through the issue of limitation and further notices (at the time the programme is approved). But over the years, successive assurances have been given both in Parliament and elsewhere to licensees limiting the use of these powers to constrain production. These assurances are described in Annex III. In addition, licensees of some fields have received separate individual assurances.

philosophy

4. The Government's general philosphy on depletion policy is that powers to control production would be used only in condition of extreme market crisis. Without such a situation and without careful preparation of the case with the licensees, use of the powers would severely undermine confidence in the UK's offshore regime. It would probably be resented by the industrialised countries who would accuse the UK of shoring up OPEC prices. It would also be expensive; each cut of 100,000 b/d would cost the Exchequer up to £700 m a year.* Nevertheless if Ministers were prepared to accept these disadvantages and to breach their more recent assurances then UKCS output could be reduced by an average of 250,000 b/d for 1984 as a whole but the actual reduction would fall mainly in the second half.

(d) Refuse Consent to Increased Production Levels

5. Production from one field, Forties, exceeds the approved profile by considerable amounts. Consent to the excess production has been given quarterly: and has now been renewed from 1 January. It would be possible both legally and consistently with the assurance not to cut production before 1 January 1985 to limit production from that field to the approved profile. We are unlikely to have technical reason not to renew the consent at its current high level from 1 April. Failure to renew at that level would kindle speculation that HMG was changing its

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* (depending on the fields from which production is cut back)

policy on production constraints even though there is a clear difference between not agreeing to increases in production and cutting already approved levels. However, renewal of the Forties consent at the high level in January has given us scope for cutting production in April, should Ministers judge it necessary to do so, without breaching the letter of any assurance. Assuming that a decision were taken on 1 February to limit production from the UKCS, then we could cut by an average of about 30,000 b/d (possibly increasing to 67,000 b/d) (Forties only) from 1 April without breaching the assurances.

(e) Voluntary Production Constraints

6. Licensees might be persuaded that it was in their longer term commercial interests to reduce production. However voluntary agreement to reduction would not be forthcoming unless licensees believed that the additional value of the shut-in-oil when it was later produced would more than recompense them for the interest on the value of the production foregone. Moreover in some fields, the number of licensees and the undertakings they have given to raise finance make such voluntary reductions very unlikely unless the price of oil were to fall to, perhaps, $10-15.

(f) Storing Royalty-in-Kind Oil

7. HMG might store its royalty-in-kind by leaving it in the fields. That could not be done without the consent of the licensees. It would be complex both technically and in accounting terms to account for and recover it - indeed some might never be recovered. Recovery would require eventual compulsory production cuts. For each 100,000 b/d production reduced through such an approval, the loss in revenues would be nearly £750 m a year.

(g) Time Swap

8. Effects similar to a cut but without breaching the assurances might be achieved by a time swap with an OPEC country. In effect the UK would pay that country in 1984 to produce below its agreed quota; in 1985 the UK would cut production by more than the agreed

amount and be repaid by that OPEC country. But that would be difficult to account for unless the crude were of similar quality and value. Those OPEC countries with crude most similar to ours (e.g. Nigeria) also have precarious finances and could not be trusted to repay the revenues later.

ANNEX III

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ROYALTY (RELIEF) BILL: SECOND READING DEBATE

DEPLETION POLICY ASSURANCES

Background Note

1. The "Varley" assurances relating to the then Government's policy towards the control of the depletion of UK Continental Shelf oil, were made by Mr Varley when Secretary of State for Energy, on 6 December 1974. The assurances given were that:

(a) no delays would be imposed on the development of oil fields discovered at that time or on fields discovered up to the end of 1975 under licences which were then in force;

(b) no cuts would be made in production from such fields until 1982 at the earliest or until 4 years after the start of production, whichever was the later;

(c) no cuts would be made in production from any field found after 1975 under licences which were then existing until 150% of the capital investment in the field had been recovered;

(d) if depletion powers had later to be used, full regard would be had to the technical and commercial needs of the fields in question, which would generally limit cuts to 20% at most.

2. The present Government stated on 23 July 1980 that they would honour the assurances given by Mr Varley, on the basis of which heavy investment had been undertaken by the oil companies. The Government would however consider delaying the development of fields discovered after the end of 1975 which were not covered by the Varley assurances (and under this heading, the Clyde field was delayed for 2 years).

3. The 1980 statement left open the question of production cut-backs which the terms of the Varley assurances would permit the Government to apply in certain cases after the beginning of 1982. Mr Lawson announced on 8 June 1982 that such cut-backs would not be imposed at least until the end of 1984 in order to allow the oil industry a firmer basis for their exploration of and investment in the UK Continental Shelf. The Government would however ensure that the development of new and existing field proceeded on the basis of good oil field practice and that the wasteful flaring of gas was minimised. Also in 1982, the Government's reply to the report of the Select Committee on Energy on North Sea Oil Depletion Policy made clear in detail that the Government's policy remained as in the 1980 and June 1982 statements and that no economic case existed at present for imposing further delays on development. The Government would however retain such reserve powers of intervention as were available to it against the

possibility of some substantial and unforeseen change in circumstances.

OIL 3A
4 July 1983

20 JAN 1984

Prime Minister (4)

CONFIDENTIAL

MR TURNBULL

2 December 1983

THE OIL MARKET GENERALLY

UKCS spot crude prices are currently about $1.25-1.50 / barrel below term prices. This reflects a general weakness in the market although the recent Shell refinery strike has probably helped to depress UKCS prices. This strike ends on Monday but was forcing Shell to dump quantities of Brent crude on to the spot market.

Setting aside possible developments in the Gulf, the general prospects in the oil market are fragile but do not give immediate cause for concern.

OPEC were at over 1 mbd above the agreed production ceiling of 17.5 mbd during the third quarter. However, they have recently been edging back towards the production ceiling and the effects have yet to be fully reflected in the spot price. The OPEC meeting in Geneva on 7 December is expected to reinforce the current term prices and quotas, despite the misgivings of some members.

With reasonable luck, BNOC term prices should not come under serious pressure during the remainder of this year despite continued weakness in the market.

The prospects for next year depend upon the extent of the world recovery. Although the position will remain fragile, average OPEC demand is unlikely to fall below 17.5 mbd. There is a reasonable chance, therefore, that a major destabilising crisis can be avoided.

In these circumstances, the UK should continue to resist any OPEC proposals for co-ordination on production levels, particularly as UKCS production levels are now probably past their peak.

DLP.

DAVID PASCALL

CONFIDENTIAL

Prime Minister (4)
To note

AT 7/10

MR TURNBULL

7 October 1983

cc Mr Mount

Thanks on this helpful very much

OIL PRICES

UKCS spot crude prices are currently about 50-75 ¢ / barrel below term prices. The weakening of the spot market has occurred during the last week and reflects a general realisation that the market in the 4th quarter is likely to be slacker than expected.

Three main factors have contributed:

1) demand expectations are being revised downwards after earlier optimistic assessments, particularly by the US companies, of the impact on oil demand of economic recovery;

2) supply has increased as all OPEC members with the exceptions of Iraq and Kuwait have edged above their production quotas. OPEC are currently producing oil at about 1 million barrels per day (mbd) above the agreed OPEC ceiling of 17.5 mbd;

3) as a consequence of the above factors, planned stock levels now look too high and some stock reductions are expected during the 4th quarter.

The expectation, therefore, is that the spot market will remain weak although it seems unlikely that BNOC term prices will come under serious pressure during the remainder of this year. BNOC are experiencing some difficulties in reaching agreement on their proposals for the 4th quarter but they are confident that these can be overcome. A cold winter or increased fears about the Gulf of Hormuz could change the situation and the OPEC Monitoring Committee meeting on 27 October may restrain current OPEC production. Nevertheless the position is fragile.

The prospects for next year look potentially more serious and there is a possibility that the events of early 1983 may be repeated. OPEC demand is likely to fall back towards 17.5 mbd in the second quarter and it will be a test of OPEC's unity whether production will be trimmed back.

In such a situation BNOC will need to ensure that UK CS prices remain competitive with Nigerian prices in order to reduce their vulnerability in a deteriorating market. The UK should continue to resist any OPEC proposals for co-ordination on production levels. This is unlikely to have any effect in stabilising the market in the future, would reverse earlier assurances and run counter to our policy of relying on market forces for the optimal development of the North Sea.

Although 1984 will be a difficult time in the oil market, and the outlook remains uncertain, there is a reasonable chance that a major destabilising crisis can be avoided.

DLP.

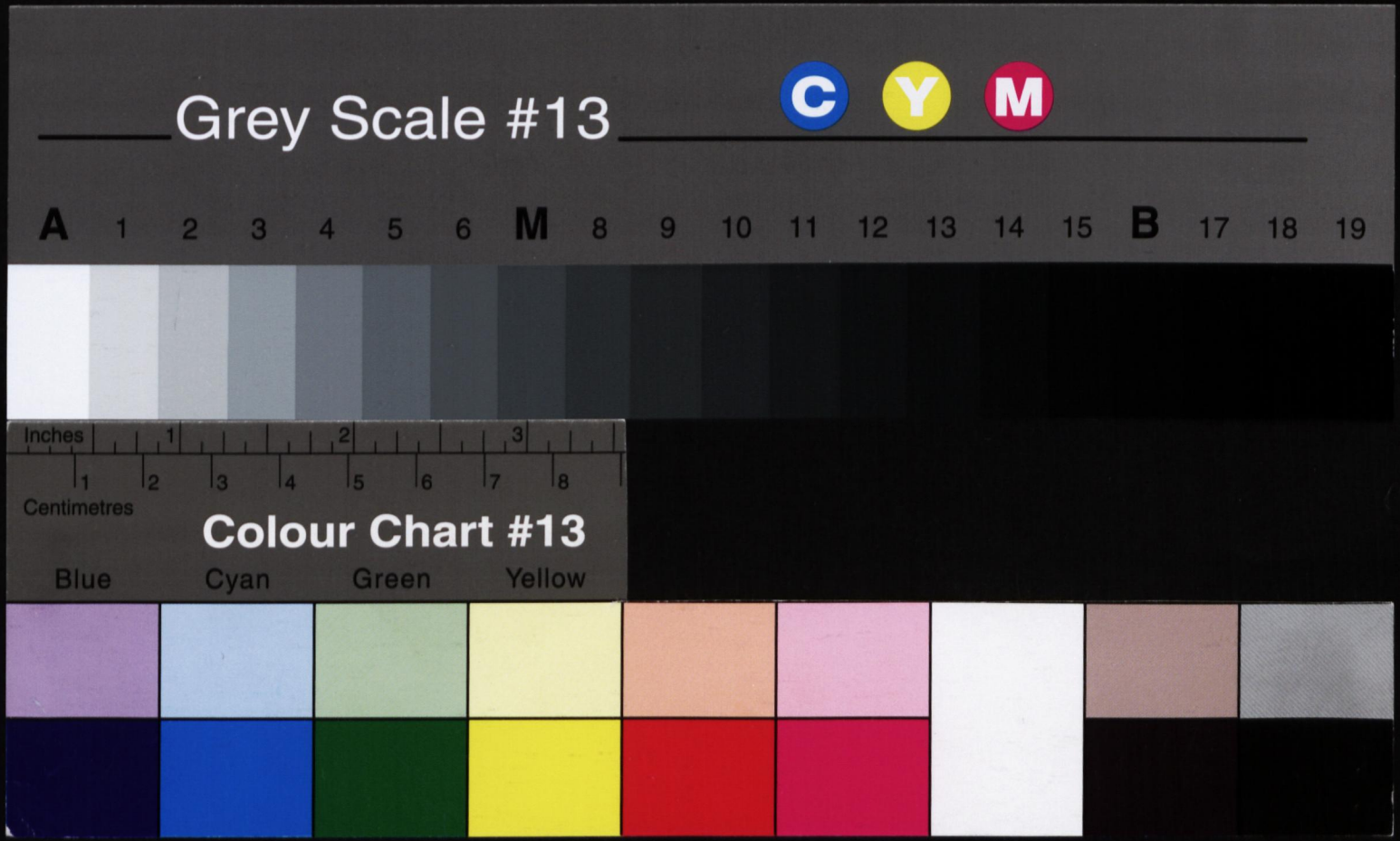
DAVID PASCALL

PART 1 ends:-

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

PART 2 begins:-

D. Pascall to AT 7/10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