(4)

Prime Minister
Worth a quick glance. The point about a shortage of refining capacity (at 'X') is important.
BHP 7/9

MR POTTER

7 September 1990

Mr Guise thought that the Prime Minister would be interested in the attached note on oil prices prepared by John Wybrew (now of Shell, late of the Policy Unit).

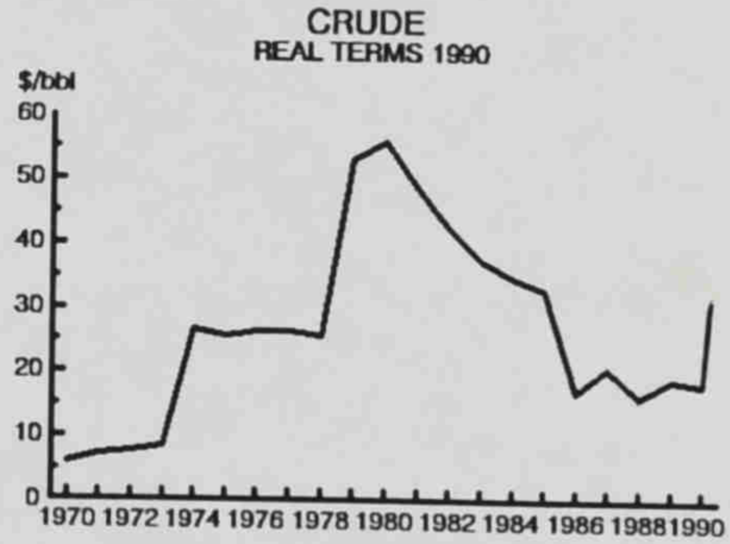
Howell Harris Hughes

HOWELL HARRIS HUGHES

THE GULF CRISIS, OIL MARKETS & PETROL PRICES

Talk of an impending oil supply crisis is ill-founded unless war breaks out. The open, market-based international oil industry is adjusting relatively smoothly to the loss of oil exports from Iraq and Kuwait. Left to work, oil markets will prevent a manageable problem becoming a supply crisis - another "oil shock".

Even at today's nervously high levels, oil prices in real terms are not exceptional by historic standards.



World Oil Supply and Demand

Provided that the Gulf crisis is confined to the suspension of oil exports from Iraq and Kuwait, world oil supplies over the coming winter will be tight but by no means precarious.

The current loss of oil exports from Iraq and Kuwait - 4.3 million barrels per day (mb/d) - can be made up by a combination of:

- boosted oil production, of some 3 mb/d, notably from Saudi Arabia, the United Arab Emirates, Nigeria and Venezuela;

- the reduction of oil demand induced by increased oil prices - upwards of 0.5 mb/d if oil prices stay up;

- the re-entry of high-cost marginal oil producers in the US who, given a buoyant price outlook and time to mobilise, could contribute perhaps 0.5 mb/d of extra oil.

Shell's analysis (attached) of the balance of world oil supply and demand - excluding the Eastern Bloc - foresees fourth quarter 1990 (QIV 1990) demand of 53.6 mb/d being balanced by drawing down the industry's commercial stocks by 1.6 mb/d; and likewise by 1.1 mb/d in QI 1991 to balance the peak winter demand of 54.1 mb/d. Thereafter, the summer of 1991 should provide breathing space for an adequate rebuilding of stocks.

Such a run-down of the industry's commercial oil stocks over the northern winter is normal and, because of OPEC's over-production earlier this year, the industry was generously stocked at the start of the Gulf crisis. Bear in mind that the free world oil industry began the year 1989 with commercial oil stocks equivalent to 67.4 days of forward demand. On Shell's analysis, the equivalent stock position at the beginning of 1991 will be 67.6 days of forward demand, indicating that the fundamentals of oil supply and demand are not of themselves cause for alarm - and arguably not such as to justify the early release of strategic stocks.

This analysis assumes that Saudi Arabia's key oil installations will not be damaged by military action. Particularly crucial is the Ras Tanura oil terminal in the Eastern Province of Saudi Arabia. It exports some 4 mb/d, the loss of which in current circumstances would certainly trigger an oil supply crisis. No oil installation in the Gulf needs to be defended more carefully.

X Since the Iraqi invasion, international prices of oil products have risen proportionately higher than those for crude oil, indicating that the world's refining capacity is if anything a greater source of concern than oil production capacity. Even before the invasion, the world's refineries were more heavily loaded than they have been for over a decade - and facing growing difficulties in meeting the more demanding product quality requirements of a "greening" world.

The loss of Kuwait's sophisticated 600,000 b/d export refinery, coupled with the dedication of a 200,000 b/d Saudi export refinery to support for the military build-up in Saudi Arabia, has put a particular strain on oil products markets east of Suez. Throughout the world the tightness of refining capacity will be accentuated by the fact that most of the incremental crude oil replacing exports from Iraq and Kuwait is heavy and therefore needs more complex refining processes to meet the market requirement for light oil products - petrol, diesel and aviation fuels; prices for these products will be under particular pressure.

Market Sentiment

The fundamental picture of a tight but not precarious balance between future oil supplies and demand is not reflected in today's nervous market sentiment and correspondingly high price levels. The fear of short term military action further disrupting oil supplies from the Gulf encourages the temporary husbanding of stocks and the taking of trading positions in anticipation of a rising market.

What then is the outlook for oil prices? Shell's view is that crude oil prices are unlikely to fall below $25 a barrel while there is a threat of Iraqi military action disrupting oil supplies from the Gulf. Conversely, the immediate nervousness which has driven oil markets to their current heights should diminish before long. The effect of any military action will depend on the damage to oil installations and the consequent disruption of oil supplies from the Gulf.

Looking beyond the crisis, few in Shell foresee structural changes leading to sustained high oil prices much above $20 a barrel.

UK Petrol Prices - Market Structure and Pricing Principles

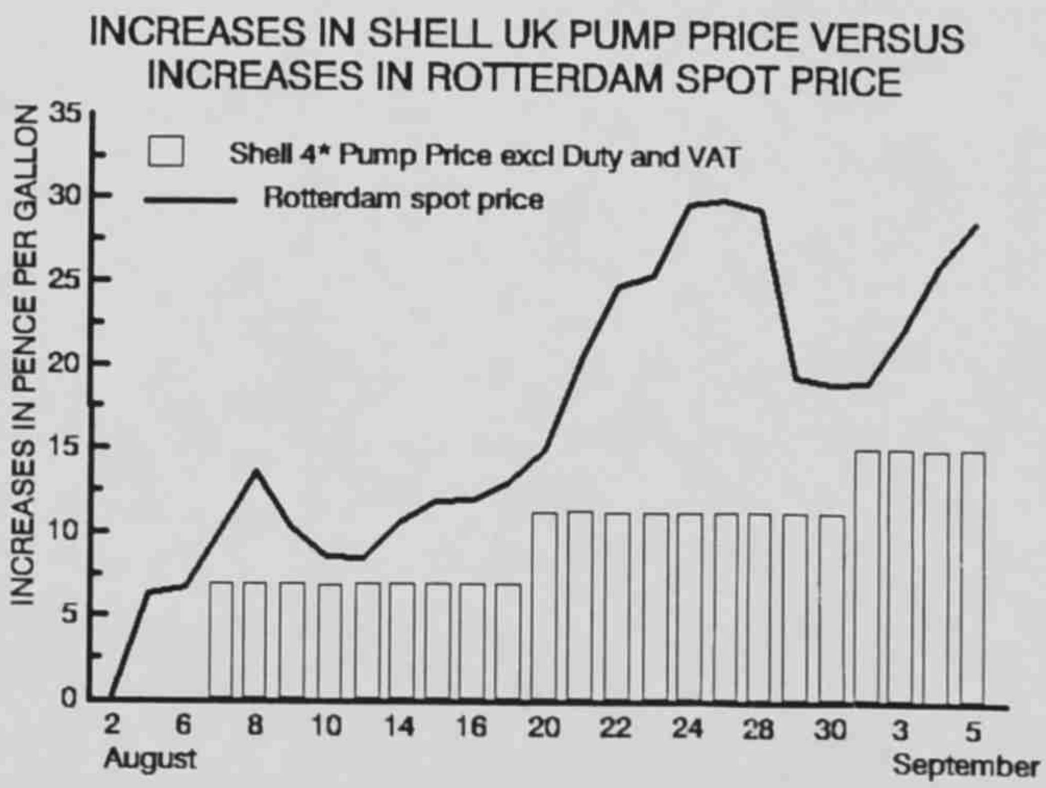
The vigorously competitive petrol market in the UK has responded in a restrained and orderly way to the current situation.

The recent exhaustive enquiry into petrol wholesaling by the MMC concluded that the market structure and pricing policies of the UK oil industry are sound, fair and work to the advantage of consumers by facilitating competition between a variety of players.

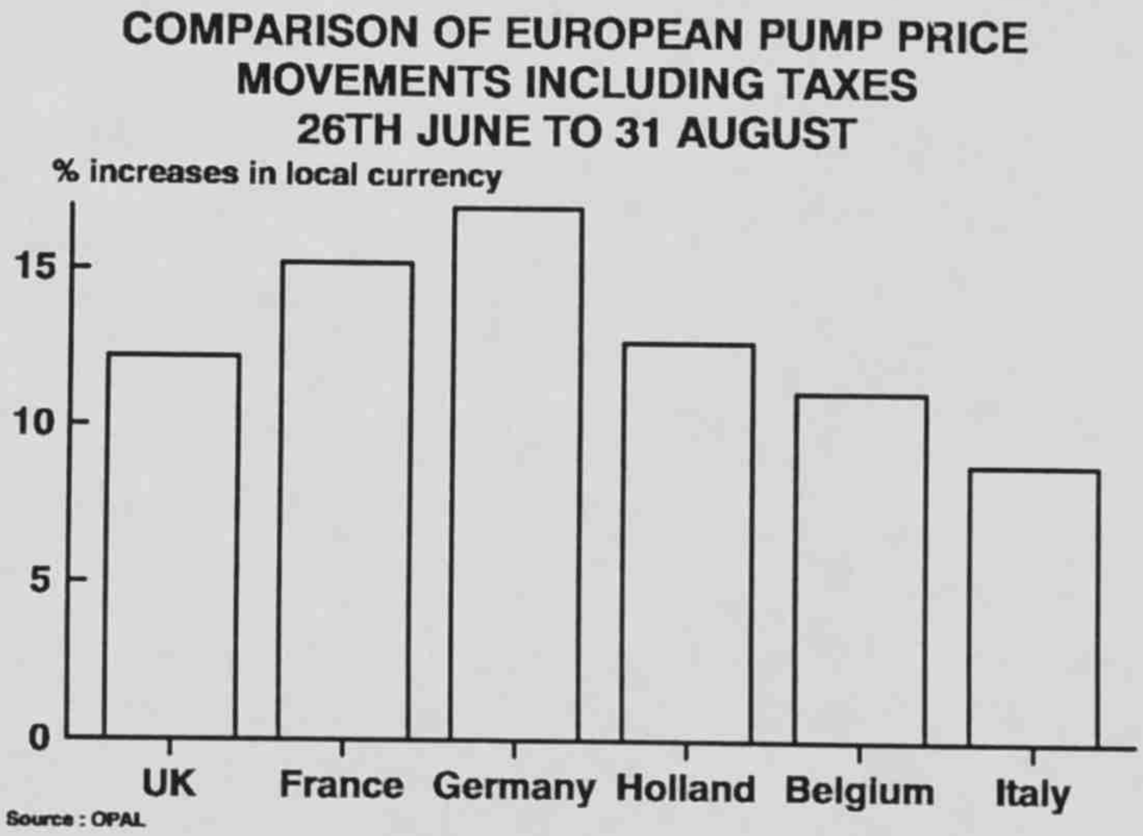
In particular it noted that the use of international (Rotterdam) spot prices as the benchmark for determining the wholesale price of petrol ensures competition on equal terms between the integrated oil companies and the 60 or so independent wholesalers in the market. Also, the separate special taxation of oil production means that up to 80% of the increased value of North Sea production from any oil price rise goes to the Government.

On the popular criticism that the oil companies are quick to put up prices and slow to reduce them, the MMC noted that the big oil companies who lead petrol pricing in the UK tend to exercise restraint in a rising oil market for fear of antagonising consumers and losing market share. In consequence, they delay price increases and, when one moves, the others follow sharply. This was seen as evidence of competition, not collusion.

Such restraint has certainly been the case during the period since the Iraqi invasion.



Like the UK, other Western European countries use the Rotterdam spot price of petrol as the benchmark for determining the wholesale price of petrol. In consequence, the pump price of petrol has moved up by much the same percentage amount across Western Europe. In percentage terms, the increase in Italy has been moderated by the particularly high level of taxation there.



John Wakeham.

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INDUSTRY SUPPLY/DEMAND AND STOCK PROFILE
World Outside East Bloc
(million b/d)

	1989	1990					1991				
	Year	I	II	III	IV	Year	I	II	III	IV	Year
DEMAND	51.5	53.0	50.9	51.7	53.6	52.3	54.1	51.6	52.3	54.5	53.1
SUPPLY											
Opec - crude	21.7	23.5	23.2	21.4	21.8	22.5	22.7	22.9	23.5	23.8	23.2
NGLs	1.9	2.0	1.9	1.9	1.9	1.9	2.1	2.1	2.1	2.1	2.1
Non-Opec	25.8	26.3	26.0	25.7	26.4	26.1	26.6	26.4	26.5	26.3	26.5
East bloc	2.2	1.7	2.0	2.3	1.9	2.0	1.6	2.0	2.2	1.9	1.9
Stockdraft/(build)	-0.3	-0.5	-2.3	0.4	1.6	-0.2	1.1	-1.8	-2.0	0.4	-0.6
TOTAL SUPPLY	51.5	53.0	50.9	51.7	53.6	52.3	54.1	51.6	52.3	54.5	53.1
		Jan90	Apr90	Jul90	Oct90		Jan91	Apr91	Jul91	Oct91	Jan92
Opening Stocks billion bbl	4.74	4.85	4.90	5.11	5.07		4.92	4.82	4.98	5.16	5.12
of which strategic	1.21	1.24	1.26	1.25	1.26		1.26	1.26	1.26	1.26	1.26
Days of supply	90.6	91.6	96.2	98.9	94.6		90.9	93.4	95.3	94.7	92.8
of which commercial	67.4	68.1	71.6	74.6	71.1		67.6	69.0	71.2	71.6	70.0