Mr Alexander –
Too late!

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

P.a.
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17/1

PRIME MINISTER

UKCS CRUDE OIL PRICES

I have seen a copy of David Howell's minute to you of 14th January in which he recommends that BNOC try to settle UKCS crude oil prices at around \$32-\$33, without recourse to arbitration. I have also seen Nick Ridley's comments of 15th January and David Howell's further minute of today.

2. I agree with David Howell's recommendation. It seems that there is a real prospect that arbitration would result in higher price, which, as David Howell points out, could lead to leap-frogging increases by the African producers. This would be unwelcome, particularly if our defence that we have been forced to that price would not in practice lessen the criticism.

3. I also agree with David Howell's proposals that additional money should be offered in the form of a supplementary payment or surcharge on a basic price of \$29.75 for Forties crude.

4. Finally, I think that it would be worthwhile making clear to, for example, the Germans and Americans our difficulties in reaching a decision though, of course, we should do this in a way which does not suggest to them that they have any say in our decision. But an early approach to the Germans and Americans might help disarm any adverse reaction.

/5. I am sending

5. I am sending copies of this minute to Peter Carrington, David Howell and Sir Robert Armstrong.

(G.H.)

17 January, 1980

17 JAN 1980

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CONFIDENTIAL

file K6

cc Ld Privy Seals Office

ENERGY

10 DOWNING STREET

From the Private Secretary

17 January 1980

The Prime Minister has considered your Secretary of State's minute of 14 January about UKCS crude oil prices, the minute of 15 January from the Minister of State, Foreign and Commonwealth Office, and Mr. Howell's further minute which came in yesterday.

The Prime Minister has decided that, on balance, it would be best if BNOC stood firm on a price of $30 per barrel in their negotiations with the oil companies. She believes that if BNOC take a tough line in the negotiations and insist on $30, there is a good chance that the companies will not challenge them. But if in the event the companies insist on arbitration, she believes the political and tactical advantages of this course outweigh the risk that arbitration will result in a higher price than the $32 to $33 level which BNOC have asked if they can be authorised to settle at. If there is to be arbitration, this must be, and be seen to be, at the request of the oil companies: the Prime Minister does not wish BNOC to offer arbitration.

I am sending copies of this letter to George Walden (Foreign and Commonwealth Office), John Wiggins (HM Treasury) and Martin Vile (Cabinet Office).

T. P. LANKESTER

W. J. Burroughs, Esq.,
Department of Energy.

CONFIDENTIAL

PRIME MINISTER

UKCS CRUDE OIL PRICES

You agreed last week that BNOC should try to reach agreement with the North Sea companies on a first quarter price of around $30 per barrel. But you also asked, in case they were unable to reach agreement on this price level, for an assessment of the pros and cons of the arbitration approach.

Mr. Howell, in his minute at Flag A, now says that the oil companies without refinery interests here - mainly American companies - will not accept a $30 price. (BP, which of course does have major refinery interests, are reported to be willing to accept a $30 price. But Energy say that it is only because they want to maximise their downstream profits and minimise their upstream profits so as to reduce their tax liability. If they sell crude at $30 to BNOC, their refineries can buy it back at $30; but they still will increase their end product prices and thus increase their downstream profits). Mr. Howell proposes that we should authorise BNOC to reach agreement on a price of $32 to $33 - to comprise a basic price of about $30 plus a "temporary surcharge".

Mr. Howell has only dealt cursorily with the suggestion that it might be better to go to arbitration. His conclusion, supported by his further minute at Flag B, is that arbitration is to be avoided. His reasons are:

(i) Arbitration is likely to result in a higher price. The minutes do not say what this is likely to be. But on further probing, I am advised that it is most likely to be between $34.50 and $35 - though the Department emphasise that it is very hard to form a view on this.

(ii) Mr. Howell does not think that international reaction will be influenced by the <u>method</u> of determining prices; instead, he believes that it will be

/wholly

wholly conditioned by the level of prices which emerges. He is particularly concerned about the African producers and, to a lesser extent, about Middle East producers, who - he believes - will take a higher price as a cue for further price increases.

The FCO have minuted (Flag C) that there are strong tactical arguments for going to arbitration, provided this route does not result in a price higher than $34.50 to $35. If it was likely to result in a higher price, they would go along with Mr. Howell's proposal that BNOC be authorised to negotiate prices in the $32 to $33 range.

The difference in the price which would be likely to result from arbitration is not all that great. In any case, the economic arguments are not necessarily against our going for a higher price. Higher North Sea prices, of course, mean higher PRT and other payments to the Exchequer. These could be entirely offset if our higher prices triggered off higher prices elsewhere, and thus further damage to the world economy and indirectly to our economy. The outcome - to say the least - is uncertain.

This is a difficult decision to take - not made easier by Energy's inability to provide a proper assessment. The point in the political equation which Mr. Howell does not mention is the likely reaction of our Western allies: as you have said, arbitration - especially if demanded by American oil companies - could make our position vis-a-vis the Americans much easier. The counter-argument, which I am told Mr. Howell espouses, is that by not going to arbitration we could take credit for not allowing North Sea prices to rise to "market levels".

The Chancellor held a meeting on this issue this afternoon. He is inclined to support Mr. Howell because he wants to minimise the risk of leap-frogging by African producers and because he feels we will get the opprobrium for further price increases whatever our approach. But he accepts that the decision is finely

/balanced.

balanced.

Mr. Howell wants a decision today.

My own instinct is that BNOC should be told to stand firm at $30, and if the oil companies will not accept this, the agreed arbitration procedures - which involve the two sides calling in an independent expert valuer - should be allowed to take their course.

16 January 1980

Not a cent above Nigeria.

$29 - 75 (?)

I doubt very much whether American Co's will challenge that - they would have to take into account the effect of such action on their own future reputation.

MT.

B

PRIME MINISTER

UKCS CRUDE OIL PRICES

Since we need to take a decision today on UKCS oil pricing, I should comment quickly on Nicholas Ridley's minute to me of 15th January.

The arbitration route in fact embraces the procedure set out in his third paragraph. If we follow this route, BNOC will, of course, stick on their present offer and the companies in question on their rejection. The contract then provides for resolution by an expert, by a defined procedure. This is not an additional option. If the price goes up for the arbitrated minority it will go up for all the majors as well.

Newspaper reports of BP's action should not be given much attention. What BP has done is to set a provisional price for UKCS oil transferred to its own affiliates. My minute to you of 14th January explained that it suits an integrated company to set a relatively low price and take its profits downstream. We have tested informally the weight likely to be attached by an independent expert to evidence of internal pricing by BP (or any other major, integrated company) and, as we expected, this would <u>not</u> be regarded as an objective valuation.

We are left with the original dilemma I posed: that the UKCS price is going to rise, one way or another, above the official price of at least some African crudes and that this will attract criticism from oil consuming countries. The judgment we have to make is whether resort to independent determination is likely to do more harm than good. My view is that a price set by an independent expert is likely to be <u>higher</u> than a revised price negotiated by BNOC, though it is not possible to say whether the expert's price would be above or below

Libyan official price: $34.50-35.0

the current Libyan price (remembering that it is not official prices which gauge the world market price, but the price at which term transactions are actually taking place in the market). It is my judgment that it will be the absolute level of the price finally established which will determine international reaction and that any international credit won by the choice of route to the price will be dissipated as soon as that price emerges, especially if it is unnecessarily high. I therefore re-echo my recommendation that I should be authorised to tell BNOC today to make revised offers in the range of $32 to 33.

I am sending copies of this minute to the Secretary of State for Foreign and Commonwealth Affairs, the Chancellor of the Exchequer and Sir Robert Armstrong.

DH

SECRETARY OF STATE FOR ENERGY
16 JANUARY 1980

C

Secretary of State for Energy

cc: Prime Minister
Chancellor of the Exchequer
Sir Robert Armstrong

UKCS CRUDE OIL PRICES

You asked for quick reactions to your minute of 14 January to the Prime Minister, and I am responding in the absence of Peter Carrington and Ian Gilmour.

2. As you say, either of the options you mention is likely to result in a price for UKCS crude above the current official price for Nigerian crude. International criticism will be inevitable, more especially if other producers take the occasion to raise their prices; and it will come at a particularly awkward time in view of the EEC budget negotiations, and of American criticism of BP and Shell purchases from Iran.

3. I wonder whether there is not a further option available to us, namely to make the companies take the initiative in seeking independent valuation. There is a difference presentationally between BNOC calling in a valuer (which could be misrepresented overseas as a tacit arrangement between BNOC and the companies to seek respectable outside support for proceeding to higher North Sea price levels), and the companies taking to arbitration a BNOC which had indicated its firm preference to stick to $30. Such a procedure would tend to depoliticise the matter, and to emphasise that the decision was not one for the government.

4. I note that the companies who want higher prices only account for some 20% of BNOC's oil availability, and that many of

/these

these are American-owned. The majors appear to be content with $30. Today's newspapers report that BP is already charging its customers a reference price of "29.75 and that BNOC have said that BP's new price is identical with their evaluation of Forties type crude. Is there not a case, therefore, for encouraging BNOC to settle now with as many oil majors as possible at a price around $30; to let themselves be taken to arbitration by the independents; and to cite the majors' willingness to settle at $30 as justification for their own view of the correct market price? This might help the arbitrator to arrive at a lower figure than the independent companies want.

5. If the effect of arbitration in these circumstances would be likely to set a price level roughly comparable to that which BNOC are prepared to concede anyway in negotiation, then I think there are strong tactical arguments for so proceeding. If, on the other hand, your advice is that the outcome of arbitration might be a price higher than the highest current price for comparable curde, ie the Libyan price of around $34.50-35, then I would agree that the arbitration route, despite its attractions, would not work to our advantage. In that case, I would see attraction in your idea of a basic price plus a temporary market surcharge. But we should be careful to present the surcharge as something justified only by our view that the market may shortly slacken, and not as a permanent feature of North Sea pricing: the latter interpretation would serve to encourage other producers to look for gimmicks to camouflage price increases. I would hope also that negotiated prices will not go above the range of $32-33.

15 January 1980

Nicholas Ridley
(Approved by the Minister of State and signed in his absence)

A

PRIME MINISTER

UKCS CRUDE OIL PRICES

BNOC has, as we agreed, been seeking to reach agreement with its supplying companies on a 1st Quarter price of around $30 per barrel for UKCS crude oil taken under participation agreements.

It is now apparent that although a price around this level would provide a basis for agreement with UK refiners, who buy more oil from BNOC than they sell to it and would prefer to take their profits and pay tax downstream, it will not be acceptable to those companies without refinery interests in the UK and who account for some 20% of BNOC's oil availability. This latter group of predominantly American companies has firmly rejected an offer price of around $30 and put in counter claims of between $32 and $33.50 depending on crude qualities. An attempt has been made by BNOC (including invoking the help of the US Administration) to urge the companies concerned to moderate their demands, but to no avail.

BNOC tell us that the weight of evidence that the free market price is around the $32 to $33 level is so strong that it is unrealistic to suppose that further Government pressure would serve any useful purpose. During the last week term supplies of oil from the USSR have been traded at prices in excess of $33, and Libyan oil has been resold, again on a term basis, at prices ranging from $38 to $40. BNOC judge that overt intervention by Ministers will provoke more determined opposition than in the past on the grounds that the terms of its participation agreements, which provide for prices to be determined as between a willing buyer and a willing seller, are being overriden. All the signs are that if BNOC does not increase its offer price to around $32 to $33 or itself call in an independent expert valuer, then the companies will themselves exercise their right to go to experts within the next few days.

There are effectively two options open to us:

(i) to authorise BNOC to go ahead and reach agreement on prices, recognising that they will almost certainly have to increase their offer price to around $32 to $33 to achieve a settlement (although this could be presented as a basic price of, say, $29.75 for Forties crude plus a market related temporary surcharge)

i.e. arbitration

(ii) to invite BNOC to call in an expert valuer to settle 1st Quarter price levels.

Either course will result in a price for UKCS crude above the currently declared official price in Nigeria - though not above the price at which crude oil of this quality is actually being traded in world markets on a term basis. There must, therefore, be a risk that the UKCS crude price at this level will be used as a justification for an increase in the official price of African crudes, possibly including Algerian crude. (As you know BNOC's price increase will apply from 1 January in the usual way and there can be no complaints that this would be retrospective in an OPEC sense.)

i.e. BNOC have already notified their customers that prices go up from 1 Jan. TL

But since we are explicitly not in control of UKCS pricing decisions, there is little we can do to avoid this danger. The question for us is simply which of the two routes to a higher UKCS price is less objectionable and less damaging for our interests as an oil consumer. The option of going to an independent expert could help our international posture as a demonstration of our determination to try to set UKCS prices in the rearguard of current market levels. But BNOC believe that there is a very real risk in the light of current market developments that an expert valuer would come up with an even higher price than $32 to $33 which would, even if delayed by a week or two, be more likely to lead to leapfrogging increases by the African producers. The defence that BNOC had been forced there by an independent valuer would not in practice lessen the criticism we would face in those circumstances.

The alternative is therefore for BNOC to go ahead and reach agreement with its suppliers without resort to experts. The Corporation points out that to do so would be entirely consistent with the UK policy of following the market and would enable it to retain its credibility as a trading organisation while at the same time avoiding a potentially awkward precedent for both itself and Government in future price negotiations. In doing so, BNOC would be ready to adopt the idea of offering any additional money in the form of a supplementary payment or surcharge on a basic price of $29.75 for Forties crude, although it believes that it would probably have to commit itself to any surcharge element for the whole of the 1st Quarter. There would nevertheless still be presentational value in putting up the offer price in a way which helped to reinforce the view that surcharges and premia are a temporary rather than permanent feature of the scene. It might also reduce the risk that the Nigerians and, more particularly, the Algerians who are also pricing from a $30 base, would find an excuse in UKCS prices for further increases in their own prices.

To sum up, I believe that the balance of advantage lies in allowing BNOC to seek agreement with its supplying companies without reference to independent experts. I recognise that it will be important for posts abroad and the press to be given firm guidance about the reasons for BNOC's actions, but we have put in a lot of groundwork and I believe that there is already evidence of greater understanding both at home and internationally of our position on prices. Unless you and other colleagues object, therefore, I propose to authorise BNOC to go ahead and negotiate agreement on prices on the basis outlined above. I believe we should do this by Wednesday lest the decision is taken out of our hands by BNOC's suppliers taking it to experts.

I am sending copies of this minute as before to the Foreign Secretary, the Chancellor of the Exchequer and to Sir Robert Armstrong.

DH

SECRETARY OF STATE FOR ENERGY
14 January 1980

15 JAN 1980