CONFIDENTIAL

Original on Energy Pt3
Energy Policy. Discussion on
World Oil Situation

PRIME MINISTER

OIL PRICES AND IMPORT TARGETS

There have in the last few days been three developments which we need to consider together and on two of which we need to take urgent decision:-

(a) Iranian prices

The Iranian authorities told the oil companies including BP and Shell at the end of last week that they were increasing prices for oil under the contracts concluded at the beginning of the year by $2.50 a barrel following the increase of $2 a barrel by Saudi Arabia, Iraq, Kuwait and the Gulf States. BP and Shell are temporising but Shell loaded two tankers on 1 February the day after they received the notification. Charles Duncan telephoned me on Friday evening to say that the Americans were trying to get up a Western front against the Iranian demand and to ask us to ensure that BP and Shell did not commit themselves while discussion continued. He claimed to have the support of M. Giraud, who was in Washington, and he has been in touch with the Germans and the Japanese. The latter have in consequence told their companies to hold off for several days. Our most recent information from Washington says that Giraud has agreed that the line should be $30 for Iran. Lambsdorff told me this morning, however, that he was convinced that this attempt by the Americans to generate action was misplaced and that the right response would be a very low-key understanding on the part of all the major consumers to try and take the heat out of the market, refrain from heavy buying for a couple of months and let market forces operate for us. The Germans will certainly not welcome precipitate action on Iran.

(b) UKCS Prices

We decided last month that BNOC should be seen as a moderating influence on world oil prices by not setting a price in the first quarter of 1980 above about $30 and leaving suppliers who were not content with that

price to take the issue to arbitration if they wished. Before the spate of further price increases in the Middle East and Africa in the last few days BNOC had gone a long way towards establishing UKCS prices at least for January at around the $30 level. The fact that Libyan, Nigerian and Algerian crudes, which are the closest in quality to UKCS crudes, are now all priced above $34 makes this position no longer tenable.

(c) Import Targets

President Carter said in his State of the Union Message that the US Import ceiling for oil imports in 1980 would be 8.2 mbd (comfortably above likely outturn which we estimate at 7.9 mbpd) and that the US would be willing to reduce their target if other oil consuming countries individually join in a fair and mutual reduction. The Americans are building up heavy pressure for a reduction in 1980 targets at the IEA Ministerial planned for late March. Lambsdorff confirmed that he like us was totally opposed to the target cutting exercise and that he would seek to persuade Duncan to defer the IEA Ministerial.

2 This complex of issues is likely to dominate internationl energy discussion over the next few months leading to the Venice Summit. We need to handle them with great care if we are to safeguard UK interests and at the same time avoid damage to our relations with the Americans and/or our European partners.

3 Immediately there are two questions which need to be resolved - our response to the US approach on Iran and action on UKCS Prices.

4 Both need to be looked at against world oil prospects. Our own latest forecasts and those of the IEA suggest that demand for OPEC oil in 1980 will be about 29 mbpd compared with 31½ mbpd in 1979. Spot prices have shown a marked downturn through January and there are even suggestions now that cargoes are being disposed of at a loss. We see no sign, however, that term prices - particularly for light oils - are likely to weaken. More over the supply condition is general remains extremely fragile. But unless there is a sharp cut in OPEC production deliberate or accidental - oil prices may have reached a temporary peak.

Iranian Prices

5 Although they will try to negotiate better terms BP and Shell both feel that they have little option but to accept the Iranian demand. They need the oil (125,000 bpd for BP and 95,000 bpd for Shell). The Iranians have the right under the terms of their contracts to increase Government Selling Price at any time. The increase of $ 2.50 a barrel is only 50 cents more than that imposed by the Gulf states. If, however there were to be a firm stand which resulted in a loss of Iranian supplies, BP and Shell argue that there should be a safety net under which the Aramco partners and perhaps other US companies would give help.

6 While it is, no doubt, the case that the price now being asked by the Iranians is high for oil of that quality in relation to Gulf prices (though not in relation to North African prices) I do not share the American view that the Iranian increases can be treated in isolation as a principal destabilizing influence. On the contrary the latest Kuwait and Iraq increases and the prices set by the African producers matter far more. Concerted action on the part of consumers only makes sense at this point if it is taken as part of a united front with the moderate elements within OPEC, against irresponsible price increases more widely.

7 Unless there are non-oil reasons for trying to exert pressure on Iran, with all the risks for Shell and BP and their mainly continental European customers, I do not see how we could reasonably invite the companies to break their existing contracts.

/8 The Americans

8 The Americans have asked whether we would be prepared to hold a conference in London later this week, without publicity, to consider the Iranian issue. I am sure we should not take the lead in this way but I would be prepared to participate in an informal meeting a little later on to look at the possibilities of making use of what we see as favourable market forces in the wider context.

9 Whatever we decide we must carry the Japanese with us.

UKCS Prices

10 BNOC, if left to themselves, would now offer their suppliers a Forties crude price of $ 33.75 (with related prices for other UKCS crudes) from 1 February. They would regard this as a moderate market price which might be accepted by the oil producers as a fair recognition of what has happened in recent days. BNOC wish to avoid disagreement over price leading to a reference to experts i.e arbitration; they believe that the few independent experts are of poor quality and that the results of arbitration would be unpredictable and unsettling for the future.

11 There is some force in their view. But a $4 jump offered by BNOC could attract a great deal of international criticism even though e.g US companies have been buying at higher prices - no one would choose to believe that the BNOC offer was not inspired by HMG.

12 Ideally we would find a solution which allowed market forces to settle UKCS oil prices at reasonable levels without exposing HMG

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to the criticism that it was responsible for the results. There are two ways in which the pressures on the Government might be mitigated:

(a) by forcing the price to arbitration. This could be easily achieved by BNOC offering an unreasonably low price and sticking to it. In this way BNOC's moderation is clear and the final decision is taken by independent experts; <u>or</u>

(b) the oil producers forward their price demands and BNOC, after careful and determined negotiations, settle (as they believe they can) for not more than $34. This also can be presented as a valiant attempt by BNOC to moderate the excessive demands of the producers while avoiding arbitration which might well result in a higher price. It would of course be essential that BNOC only reacted and was not the first to propose a price.

13 (a) looks superficially attractive since it removes the decision from HMG's control. But in addition to the points in para 10 there would be a serious technical risks, eg in one case the participation agreement requires an arbitrator to choose either the buyers or the sellers suggested price. More generally we cannot really hope to escape some responsibility for what happens in a world where every producer government intervenes on pricing policies, and when we regard it as essential to retain a trading capability for our own security of supply.

14 I favour (b) above which if properly stage managed will get us back with the position of following nearly the Libyans, Algerians and Nigerians but being dragged there under duress. This should put us in the most flexible position we can hope for in the future.

15 As for the price at which BNOC sell oil to refineries, I have insisted that they give notice that this price will not be less than the price ultimately fixed at which they buy.

16 All this has implications for import targets on which I will be minuting you separately.

A suggested line:

17 I think the way through is to:

(a) tell the Americans that we do not think it is now possible to prevent the 1 February Iranian increase but that we are very ready to join in discussion with them and the other main consuming countries soon about joint resistance to future unreasonable demands by the OPEC hawks provided action is not confined to Iran (but we should not hold a meeting in London);

(b) urge BNOC to proceed as in para 13(b).

18 The US Administration clearly wish for electoral reasons to provide a convincing demonstration of American leadership at the IEA Ministerial and at Venice. This is likely to be at the expense of European interests without leading to any new action by the US to help solve its own energy problems. We must do what we can to modify these US pressures

19 You may think it useful to have an early meeting of the small group which discussed these issues before Christmas.

20 I am sending copies of this minute to Peter Carrington, Geoffrey Howe, John Nott and Sir Robert Armstrong.

JH.

5 February 1980

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Original on Energy Pt 3 Energy Policy. Discussion on World Oil Situation.

PRIME MINISTER

OIL PRICES AND IMPORT TARGETS

(The Secretary of State for Energy's minute to you of 5 February)

Mr Howell's minute, to be discussed at your meeting at 9 am tomorrow, covers three issues: Iranian prices; UKCS prices; and import targets. The first two are urgent, the latter less so. I suggest that the meeting concentrates on the price issues and leaves import targets for the time being (Mr Howell in paragraph 16 of his minute promises a separate submission on this).

2. Iranian prices: The Americans are trying to get a united front against the Iranians' latest $2.50 a barrel increase in their prices. But these new prices are not particularly out of line with the market and if we refuse to buy the Iranians will sell to others. The impact of any resulting shortfall in supplies would fall on European consumers and on Japan and on BP and Shell. The Americans would be unaffected. Moreover, this hardly seems the moment to apply a new screw to the Iranians (the Americans are themselves holding off their economic measures) Your colleagues may therefore find little difficulty in accepting Mr Howell's suggested line in paragraph 17(a) of his minute - which besides price recommends that we should not agree to holding a meeting on Iranian oil prices in London but should be ready to join in discussions elsewhere at a suitable time.

3. UKCS prices: The North African producers have moved to an oil price around $34 a barrel. BNOC is still selling similar crudes at $29.75 a barrel. We cannot afford to hold BNOC back from matching these prices (even if the independent North Sea producers would let us) and the question is how we best move to, say, $33.75 a barrel without attracting unnecessary criticism from our European partners. Mr Howell sets out the alternative techniques in paragraph 12 (a) and (b) of his minute.

He recommends (b). There is in fact no simple solution because the interests of the companies producing in the North Sea vary widely and some would welcome a low price (for tax reasons) while others would want the most they could get. Moreover, while arbitration offers a neat way out in principle the mechanics leave a great many uncertainties about the outcome. And for arbitration to take place BNOC would still have to declare its hand on prices. Mr Howell's recommendation for leaving the outcome to "careful and determined negotiation" by BNOC is probably the best way out. (The reference to paragraph 13(b) in paragraph 17(b) in Mr Howell's minute is a misprint for 12(b)).

CONCLUSION

4. It is likely that Mr Howell's recommendations on prices will be accepted. The question of import targets should be put on one side pending his further minute.

RWA

Cabinet Office
5 February 1980

P.0202

MR LANKESTER

cc: Mr Wade-Gery
Mr Franklin
Mr Mountfield
Mr Wright
Mr Kind

THE PRICE OF NORTH SEA OIL

You asked David Wright this morning for any information we could gather on current moves on the price of North Sea oil following the recent further rise in Nigerian and Algerian prices. I accordingly called in representatives of the Departments concerned for an informal discussion of the situation. Briefly:-

(a) Mr Howell is likely to be minuting the Prime Minister tonight or tomorrow morning suggesting that the North Sea oil price should be settled by arbitration. His basic argument will be that this is the best way to avoid international flak. The Foreign and Commonwealth Secretary is likely to support him on the same grounds. The Chancellor of the Exchequer's reaction is less certain because he is known to be worried about the uncertainties attaching to an arbitrator's price determination and the consequent loss of control of the revenue and balance of payments effects of the North Sea price.

(b) It is common ground, apparently, that the current market value of "forties" crude is around $33.75 or $34 a barrel as against the current price of $29.75. The difference represents a great deal of money to the Exchequer and the balance of payments.

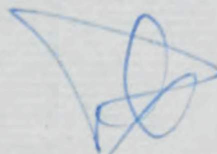
(c) Uncertainties about arbitration stem basically from the fragmented state of the oil market - with no clear "marker" on which an arbitrator can stick; variations in the arbitration clauses of BNOC's various contracts which could lead to some maverick findings (there could be a number of separate arbitrations); the restricted number of potential arbitrators available - who would know perfectly

well that they were engaged as much in a political as an economic exercise; and, in terms of presentation, the difficulty of ensuring that the initiative for arbitration came from an oil company rather than from BNOC. It is also relevant that an arbitrator could apparently fix a price for a whole quarter's supplies and thus remove the possibility of adjusting upwards to any further market rises on a monthly basis (this may be less of a danger if the spot market continues to fall as it is doing at present).

(d) In all of this it has to be remembered that the interests of the North Sea producers who are also refiners is best served by a low North Sea price (they shift their profits from the heavily-taxed upstream area to their barely-taxed downstream activities). Such companies control 80 per cent of the output. None-refining producers, on the other hand, want the highest price they can get - and this group includes most of the small "British" producers. BNOC may have to conduct some pretty elegant footwork if it is to come out of the arbitration maze with a high effective price and without itself having had to appear to be forcing the pace on the offers which it will need to make before arbitration can come into play.

(e) There is also a rather more devious longer-term argument. Arbitration is built into the Participation Agreements which were constructed under pressure from HMG. If we now use arbitration and do not like the results, we may be forced into an overtly-administered price. If on the other hand the arbitrator's price is satisfactory, more perceptive overseas critics might say that we had set up the arrangements as a perfidious device to obtain a high price without taking responsibility for it. The former is I think a much more serious risk than the latter.

2. We will of course offer advice when we know precisely what Mr Howell has recommended.



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4 February 1980