1

Prime Minister

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

FERB 28.1.

01-211-6402

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

28 January 1983

Yes - but surely they can give a [illegible] discount off list price to their larger customers? M

Dear Chancellor,

BNOC OIL PRICES

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

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

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

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

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

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

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

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

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

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

Yours sincerely

C. Brooks

NIGEL LAWSON

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

CONFIDENTIAL

10 DOWNING STREET

Lie AH
ccs FCO
D/T
Tsy

From the Principal Private Secretary

31 January 1983

Dear Julian,

BNOC OIL PRICES

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

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

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

Yours sincerely,

Robin Butler

Julian West Esq.,
Department of Energy.

AH

CONFIDENTIAL

Energy

Prime Minister

MCS 17/2

01-211-6402

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

17 February 1983

Dear Chancellor,

OIL PRICES

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

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

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

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

Yours sincerely,

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

CONFIDENTIAL

J CC JV

NBPM

MES 8/2

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

7 February 1983

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

Dear Julian.

BNOC OIL PRICES

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

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

Yours ever,

J O Kerr

J O KERR

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BNOC OIL PRICE AND TAX REFERENCE PRICES

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

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

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

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

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

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

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

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

Energy Jan 80 North Sea
Oil Prices

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Energy

ENERGY.

c/c JV

Prime Minister (2)

MCS 31/1

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

31 January 1983

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

Dear Nigel

BNOC OIL PRICES

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

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

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

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

Geoffrey

GEOFFREY HOWE

CONFIDENTIAL

Energy: North Sea Oil Prices
Jan 80

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Energy

2 pps

Prime Minister (2)

cc JV

FCS/83/15

Mcs 31/1

SECRETARY OF STATE FOR ENERGY

BNOC Oil Prices

with MCS

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

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

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

(FRANCIS PYM)

Foreign and Commonwealth Office

31 January 1983

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Energy: North Sea Oil Prices
Jan '80

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

CC JV

From the Secretary of State

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

31 January 1983

Dear Julian,

BNOC OIL PRICES

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

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

Yours sincerely,

John Rhodes

JOHN RHODES
Private Secretary

CONFIDENTIAL

010

c/c JV

Prime Minister

(2)

MCS 26/1

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

01 211 6402

CONFIDENTIAL

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

25th January 1983

Dear Geoffrey

PRICE OF UKCS OIL

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

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

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

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

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

Yours ever
Nigel

NIGEL LAWSON