Ref: B06748

PRIME MINISTER

c Sir Robert Armstrong

The Oil Price and the United Kingdom Economy

BACKGROUND

Flag A
Flag B

You are chairing an ad hoc Ministerial meeting at 6.00 pm on 24th March to discuss the Secretary of State for Energy's minute of 16th March covering a note by the Department of Energy. The Foreign and Commonwealth Secretary commented in his minute to you of 18th March.

2. The origins of the Department of Energy's paper lie in the representations made to the Foreign and Commonwealth Secretary by the Mexican President and Foreign Minister during the Royal visit to Mexico in February in favour of a dialogue between OPEC and non-OPEC oil producers. But since then, attention has focussed on the general climate of uncertainty following the precarious agreement reached with so much difficulty by OPEC ten days ago and its implications for British policy.

3. The note covers four issues in some detail.

a. Implications of a falling oil price for the United Kingdom economy. The note concludes that the balance of advantage for the United Kingdom, over a two to three year period, lies in a moderate and gradual fall in the oil price; but that a steep and fast fall would be damaging. This conclusion relies on a number of predictive judgements and quantitative assertions that could be subject to significant margins of error. This is probably unavoidable. There are however points of detail which may be open to dispute. For example, the Department of Trade contests the assertion in paragraph 3(ii) that "our exports are heavily weighted towards energy producing and self-sufficient countries", arguing that 81 per cent of British exports go to oil importing countries and only 16 per cent to oil exporting countries.

b. United Kingdom influence on output and prices. The note states that United Kingdom oil output is not on a scale which can have a significant effect on world supply and demand. The level of output is in practice controlled by the licensees, not the Government.

Fresh powers would be required if the Government wished to reduce production. The Government have taken the view that the market system should determine output and price.

c. United Kingdom relations with OPEC. The note concludes that there would be major objections to an agreement with OPEC, formal or informal. It is cool to the idea of a consumer/producer dialogue, which could in any case be unnegotiable in the face of United States and German opposition.

d. Implications for the United Kingdom line in forthcoming international discussions. The note sees no case for United Kingdom support for increased oil taxes to maintain the right long term signals to consumers about the oil price. In the European Community, the note sees some advantage in an oil import levy but not in a Minimum Support Price. It concludes that the line at international meetings (European Council, Williamsburg etc) which would be helpful to the United Kingdom would be that the fall in oil prices that has already occurred was favourable to world growth but that further sharp falls would create problems and impose adjustment difficulties.

4. As far as it goes, the general thrust of the note is unlikely to be contested. There are points of detail (eg in paragraph 3(ii), as noted above) which might justify further work by officials; and there are additional facts which are relevant and which might have been included (for example, that it is the significant quantities of Soviet oil which are being released on to the European market at well below the OPEC price which constitute one of the pressures on BNOC to cut the UKCS oil price). However none of these points is likely to alter the main conclusions of the paper. It would therefore seem profitable for the meeting to concentrate on those issues on which decisions will need to be taken in the period immediately ahead.

HANDLING

5. You will wish to invite the Secretary of State for Energy to introduce his note. The Chancellor of the Exchequer, Foreign and Commonwealth Secretary and Secretary of State for Trade will all wish to comment.

6. You may wish to focus discussion on the following points.

a. Are all agreed that the balance of United Kingdom interest lies in lower oil prices, provided that they do not fall too far and too fast? Can this be more accurately defined? Does it mean that our immediate interest is in trying to ensure that the OPEC agreement holds for the time being?

b. If so, what are the implications for UKCS oil price and production? What powers do we have to influence the price? And the rate of depletion? Should these powers (notably the participation agreements) be re-examined? If it is agreed that we neither can nor should intervene to prevent BNOC dropping the UKCS oil price by more than 50 cents a barrel, what diplomatic action should we take to explain our stance to OPEC? (The Foreign and Commonwealth Secretary should be asked to speak to the suggestions in his minute of 18th March.)

c. What should be the United Kingdom line on oil prices at forthcoming international meetings, notably the Williamsburg Summit? Should further work be commissioned by officials on the consumer/producer dialogue, oil import levy etc?

CONCLUSIONS

7. Subject to the course of the discussion, you may be able to sum up as follows:

a. note broad agreement on the analysis in the note by the Department of Energy, namely that while there is economic advantage to the United Kingdom in lower oil prices, prices should decline gradually, not precipitately;

b. agree that while the United Kingdom has no powers to determine the path of prices, it is important presentationally to be able to continue to say that we are not leading prices down;

c. agree that there would be major objections to the United Kingdom associating itself with the OPEC agreement, whether formally or informally; but invite the Foreign and Commonwealth Secretary, in consultation with the Secretary of State for Energy and the Chancellor of the Exchequer, to advise on the diplomatic action that we should take to explain our stance to key members of OPEC;

d. officials should be instructed to monitor the developing situation in preparation for the Williamsburg Summit; and to examine the structure of BNOC and the terms of the participation agreement to see if there is scope for reducing the Government's profile in relation to BNOC decisions.

David Goodall

23rd March 1983

A D S GOODALL

Qa 06300

To: PRIME MINISTER

From: JOHN SPARROW

23 March 1983

The Oil Price and the UK Economy

1. You are discussing tomorrow Nigel Lawson's minute of 16 March to you and the paper prepared by his Department.

2. I agree with him that nothing that has happened so far to oil prices justifies a departure from the Government's present policies towards North Sea oil depletion and OPEC. The real oil price is still substantially above the pre-1979 price increase level and therefore could fall. I suggest that Ministers need to look more closely at the implications of oil prices falling 'too fast' or 'too far'. If we accept that we have no influence on the pace or extent of oil price changes then it is all the more important that we have properly prepared positions for dealing with the consequences of external events beyond our control.

3. The first question is to settle whether the UK economy as a whole gains from lower oil prices. As our net oil exports are small relative to GDP and we export a third of our GDP the presumption must be that on balance we do benefit from the improved world economic outlook (three-quarters of our exports go to OECD markets). If the exchange rate follows oil prices down, UK competitiveness will improve.

4. There are two major questions requiring contingency planning if oil prices should fall sharply:

(a) What happens if the foreign exchange market over-reacts? If sterling were unduly marked down the benefits of lower oil prices could be more than offset by higher import prices with consequent damage to the Government's anti-inflation policy objectives.

(b) What happens if substantially lower oil prices lead to a sharp fall in UK oil revenues and hence a higher PSBR? Compensatory taxation on oil could help and have other advantages. There may be reasons for substituting taxation for declining oil prices - preferably on a multinational basis for reasons of competitiveness - e.g. smoothing out oil price movements, maintaining progress on energy conservation, encouraging development of non-OPEC energy sources, and EC budgetary advantages to the UK if it took the form of an oil import levy. In any event a higher PSBR could be tolerated - especially given the Government's record for fiscal responsibility - as long as the inflation risk is contained and the higher PSBR can be financed within existing monetary targets at acceptable interest rates.

5. In case oil prices fall sharply, there are three further questions which we ought to have in mind:

(a) Could Ministers envisage any future situation justifying reversing the 'hands off' current depletion policy? It might well be that with oil prices low it would be sense to prolong the period of UK self-sufficiency.

(b) What are the implications for the international banking system of any further or sharp fall in oil prices? UK banks may not be heavily exposed in the vulnerable oil producing markets like Mexico and Venezuela but they could be caught up in the consequences of further deterioration in those markets.

(c) Are Ministers satisfied that there is no set of circumstances (e.g. Middle East instability arising from OPEC collapse) in which worthwhile Western political objectives could be attained by co-operating with oil producers in the Middle East to maintain a floor price level?

6. I am sending copies of this minute to the recipients of Nigel Lawson's minute.

B.

10 DOWNING STREET

Robin

Mtg of Ministers Oil

Do you wish Cab Office
to do minutes?

Sue
23/3

No thank you.
I'll do them

PERB 23.3.

FERB

10 DOWNING STREET

Oil Prices Meeting

RTA will be accompanied by Mr Colvin at the above tomorrow.

OK ?

I have told him 'no'.

Mal

23/6/83

10 DOWNING STREET

Robin.-

John Sparrow has minuted on Oil Prices. I have included it in the meeting folder.

Content.?

Andy.

23/3

Yes

10 DOWNING STREET

Michael

Oil Prices 1800 24/3

A.D.S. Goodall will accompany RTA.

Do you wish them to supply a brief?

brief requested

~~Louie~~

Yes please

M

Roger

21/3