Cc NO.

FCS/84/22

SECRETARY OF STATE FOR ENERGY

Prospects for World Oil Market

1. Thank you for your letter of 20 January.

2. I agree with the analysis of oil market prospects in the paper you enclose, and with the conclusions set out in paragraph 11.

3. Our commercial and financial interests in some OPEC countries - notably Saudi Arabia and Nigeria - are very large, and the fact that BNOC is not an agent of the British Government is not always understood fully. If the prospect of a price collapse does emerge, it will be important to avoid the impression that BNOC are undermining the stability of the market. In these circumstances, the tactical options you list may well prove useful.

4. I agree that we should not contemplate direct measures to control UK output except, perhaps, in very special circumstances such as those described in the paper.

5. I am sending copies of this minute to the Prime Minister, the Chancellor of the Exchequer, and the Secretary of State for Trade and Industry.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
25 January 1984

ENERGY: OIL PRICES: Pt 2

25 JAN 1984

MR TURNBULL 20 January 1984

PROSPECTS FOR THE WORLD OIL MARKET

We agree that there is a reasonable chance that the world oil market price can be maintained in nominal dollar terms for the coming year although the general prospects remain fragile.

Peter Walker identifies certain tactical options which could help maintain stability. These all involve some cost and should only be considered if major difficulties emerge.

We agree that the UK should not attempt to influence the balance of supply and demand through the control of UK production. As Peter Walker points out, unilateral action by the UK would not work, and would damage confidence in our policy of relying on market forces for the optimal development of the North Sea. We are also doubtful that even a co-ordinated response with OPEC would be effective.

With the recent cold spell in the USA and general concerns about the Iran-Iraq war, spot prices are now only about 20-60c/barrel below the marker prices. OPEC production is perhaps 0.5 mbd above the production ceiling of 17.5 mbd and the general trend is downwards. All of these factors are encouraging. However, considerable uncertainties remain.

The early statements by the new Nigerian Government are reassuring but the pressures on them and the other high absorbers in OPEC to raise revenue are considerable.

There is considerable uncertainty about the likely course of the Iran-Iraq war with the possibility of significant developments in the coming months.

The behaviour of Saudi Arabia is also puzzling. They appear committed to maintaining the OPEC marker price but are currently producing more than they are selling. The excess is being stored in tankers especially chartered for this purpose. The Saudis now have perhaps 50 million barrels of oil in floating storage to the value of $1.5 billion.

The reasons are unclear. Three possible explanations are

- an ability to exert pressure on the other members of OPEC by threats to flood the market

- build up of stocks to cover a shortfall in production as new gas lines are tied in - ie a technical explanation

- concern that a flare-up in the Iran-Iraq war will close the Straits of Hormuz.

As the Saudis now appear to have greater volumes afloat than would be necessary for the first two explanations, the third reason is perhaps the most plausible. Whatever happens, at some stage this oil will have to be sold in the market.

In terms of prospects for this year, the greater pressure is likely to occur during the 2nd quarter - assuming no major developments in the Iran-Iraq war. This is also the time when demand is likely to be weakest as the Winter ends and before the effects of world economic recovery are felt in the market.

Although 1984 will therefore be a difficult time in the oil market and the outlook remains uncertain, there is a fair chance that a major destabilising crisis can be avoided.

DP.

DAVID PASCALL

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CCNO

Prime Minister (2)

To note: Mr Walker is not proposing action on any of the options at present. PM note also attached conclusions at para 11.

AT 20/1

01 211 6402

MO

The Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign &
Commonwealth Affairs
Foreign & Commonwealth Office
Downing Street
LONDON
SW1A 2AL

20 January 1984

Dear Geoffrey

PROSPECTS FOR THE WORLD OIL MARKET

We corresponded on this last November. I now attach a paper by officials.

The paper warns that, while the current world oil market price can probably be maintained in nominal dollar terms for the coming year, there nevertheless remains a significant risk of a price collapse. Such a risk would continue beyond next year.

It was agreed last spring that a precipitate decline in the price of oil was undesirable. But the UK is is no position independently to maintain a particular term price for UKCS crudes irrespective of market conditions. The most we can and ought to do is encourage stability.

The paper identifies certain tactical options which could help maintain stability, or at least avoid the appearance of initiating a fall in prices. All involve some cost. The case for pursuing them, however, is reinforced by the risks to UK interests if we were thought by OPEC countries to be undermining the stability of the oil market. The cost and effectiveness of such options depend on the circumstances at the time they might be employed.

To go beyond these and to attempt to influence the balance of supply and demand through the control of UK output would be very costly. It could damage confidence in North Sea investment, and would represent a major change in our depletion policy. In any case unilateral action by the UK would not work. I recommend against such an approach unless it appears that it is the only way of clinching an OPEC production agreement at a time of collapsing prices where the potential damage to the UK economy outweighs the disadvantages. Such a combination of circumstances appears very unlikely.

I am sending copies of this letter to the Prime Minister, Nigel Lawson and Norman Tebbit.

Yours ever
Peter

PETER WALKER

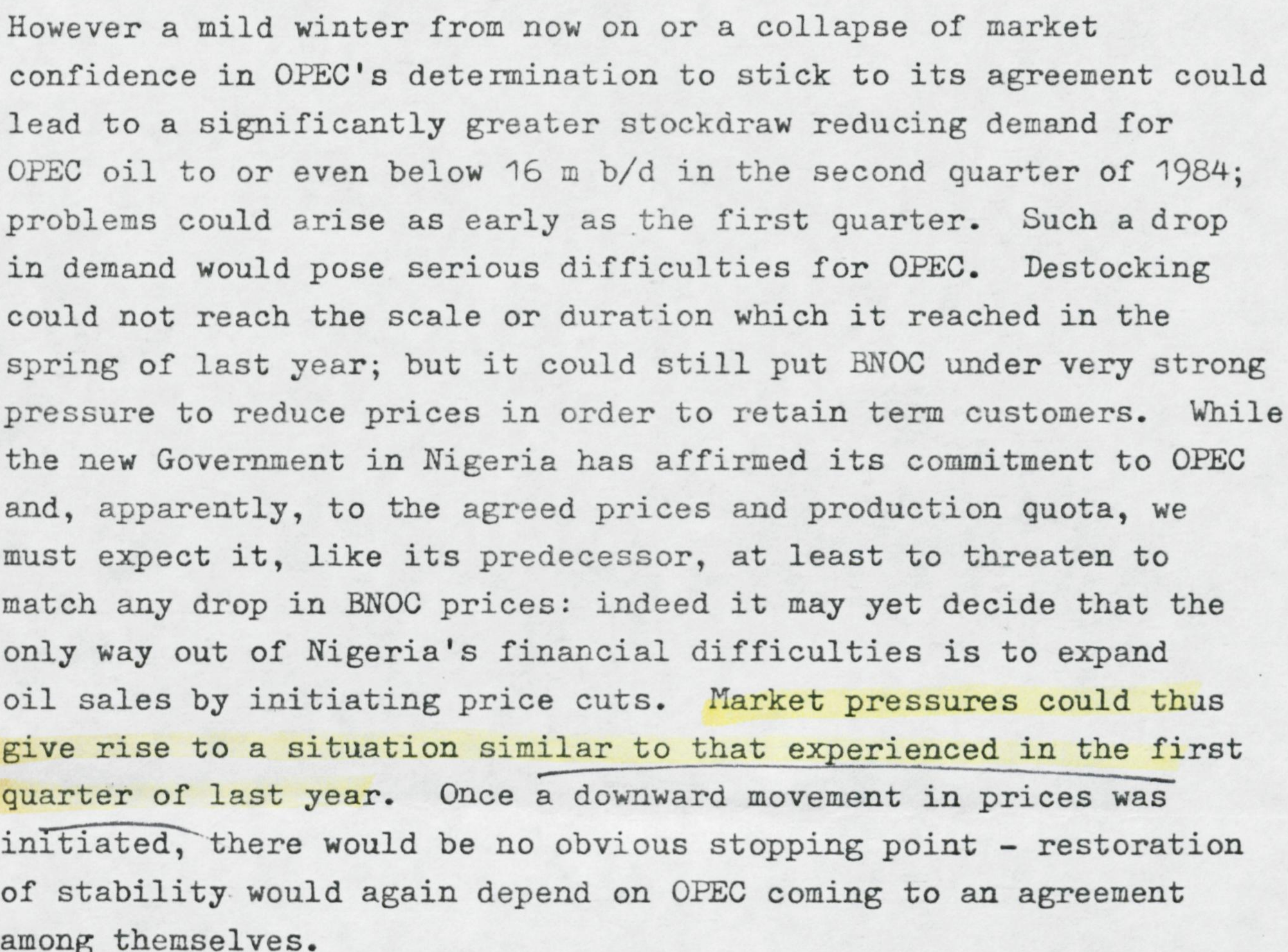
PROSPECTS FOR WORLD OIL MARKET

Report by Officials

BACKGROUND

1. In November and December the oil market weakened significantly, partly because of an over optimistic assessment in the third quarter of prospective demand leading to over-production by OPEC and particularly by Saudi Arabia. There has been discounting by certain OPEC countries. Spot prices in the US and international markets fell to more than $1.50 below term for North Sea qualities. OPEC Ministers met in Geneva from 5-7 December. They reaffirmed their commitment to the March 1983 "London agreement" to a marker price of $29 (Saudi Light) and production ceilings aggregating to 17.5 m barrels a day (m b/d). To avoid undermining the market BNOC subsequently proposed no change in its prices (based on $30 for Brent blend) for the first quarter of 1984. There was little initial reaction in the spot market either to the OPEC meeting or to BNOC's proposal. However the subsequent very cold weather in the USA, helped perhaps by statements of commitment to the London agreement by some OPEC states, in particular Iran, have since raised spot prices by around $1 a barrel. BNOC has lost only a little of its term custom; we have heard that Statoil and Britoil have also lost some.

2. If the rest of this winter in the main consuming countries is average and the oil industry follows historic patterns of destocking, demand for OPEC oil will stay comfortably above the current OPEC ceiling in the first quarter of 1984 but decline marginally below it in the second. In that case, the current marker price for term oil should hold though real prices may decline slightly either through general inflation or as a result of a decline in the relative value of the dollar or because of an increase in the proportion of sales made at discounts or lower spot prices. In the second half of 1984, demand should exceed the ceiling by a million or more b/d.



However a mild winter from now on or a collapse of market confidence in OPEC's determination to stick to its agreement could lead to a significantly greater stockdraw reducing demand for OPEC oil to or even below 16 m b/d in the second quarter of 1984; problems could arise as early as the first quarter. Such a drop in demand would pose serious difficulties for OPEC. Destocking could not reach the scale or duration which it reached in the spring of last year; but it could still put BNOC under very strong pressure to reduce prices in order to retain term customers. While the new Government in Nigeria has affirmed its commitment to OPEC and, apparently, to the agreed prices and production quota, we must expect it, like its predecessor, at least to threaten to match any drop in BNOC prices: indeed it may yet decide that the only way out of Nigeria's financial difficulties is to expand oil sales by initiating price cuts. Market pressures could thus give rise to a situation similar to that experienced in the first quarter of last year. Once a downward movement in prices was initiated, there would be no obvious stopping point - restoration of stability would again depend on OPEC coming to an agreement among themselves.

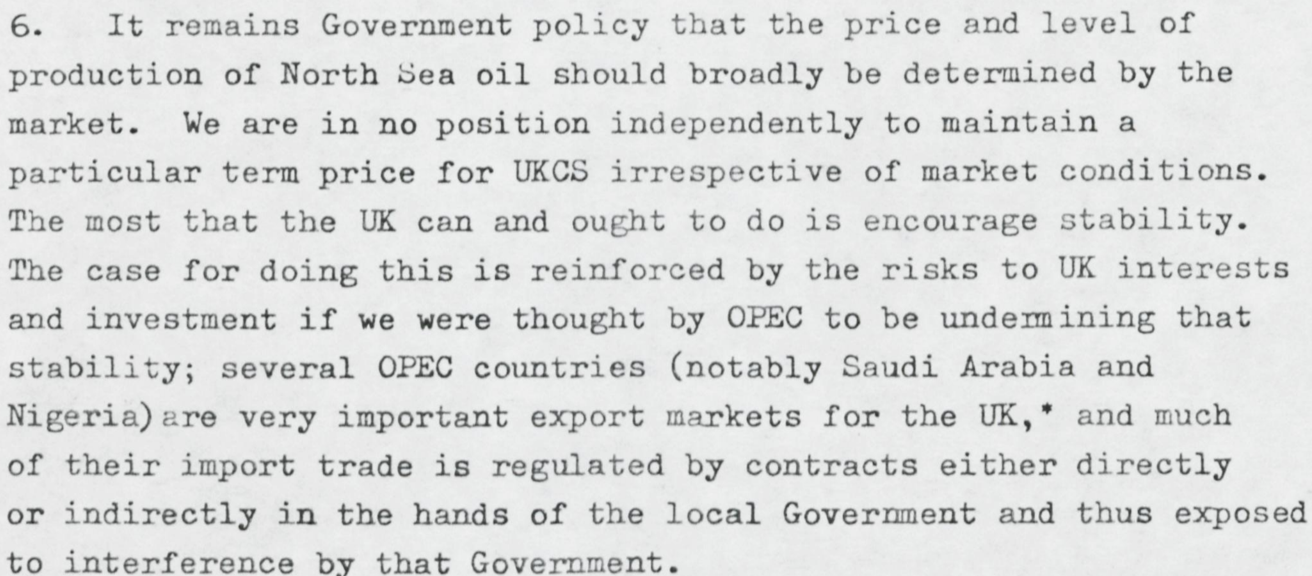
3. Accordingly, while the balance of probabilities remains that the current marker price will be retained in nominal dollar terms for the coming year, there is a significant chance of a price collapse.

4. The fundamental tensions will remain in the market even after the first half of 1984. There are no signs that OPEC's spare capacity (currently 10 m b/d against production of 17.5 m b/d) will diminish to comfortable levels within the foreseeable future. The high absorbers in OPEC will remain anxious and able to expand production to finance their development schemes. If the Iran-Iraq war ends Iraq in particular will be desperate to produce oil as fast as possible to re-establish economic strength although the

build up of production may take some time. An excess of demand for OPEC oil over the current production ceiling need not strengthen the market; indeed the immediate effect may be to encourage irreconcilable claims to that excess or price competition between OPEC countries to win that additional custom. The risk, therefore, of a fall in the price of oil will remain for some years. That fall could be considerable - to $20 a barrel if at that point the US were willing to substitute enough oil for coal in its electricity system; well below that if the floor were set by the marginal cost of meeting the current demand for oil. However so long as some production is required from the Gulf to meet current demand, such a reduction in price would be unlikely to persist unless that were the wish of Saudi Arabia and its Gulf allies.

HMG'S POLICIES

5. Ministers decided, following the $5 reduction in OPEC's marker price last spring that a precipitate decline in the price of oil was undesirable. While the UK would benefit, at least for a time from increased output and perhaps lower inflation, there would be immediate disadvantages from loss of tax revenues and the possible effect on the exchange rate; moreover there might be problems resulting from increased turbulence in world financial markets. The loss of tax revenue if the oil price fell to $25 per barrel would be £1.5 bn in the first year. However, a small fall in the nominal oil price that did not lead to a collapse in price, might well not be unwelcome. But in present circumstances even a small price reduction by one or more producers would almost certainly be trumped by further and larger reductions by others. (Only Saudi Arabia with its ability to expand or cut back production significantly may be able to engineer a controlled reduction; there is no evidence that it currently wishes to do this.) Ministers therefore agreed last spring that the UK's objective for the time being should be to avoid taking the lead in undermining the prices for oil which had emerged from the OPEC meeting in March. The analysis underlying that decision still holds.



6. It remains Government policy that the price and level of production of North Sea oil should broadly be determined by the market. We are in no position independently to maintain a particular term price for UKCS irrespective of market conditions. The most that the UK can and ought to do is encourage stability. The case for doing this is reinforced by the risks to UK interests and investment if we were thought by OPEC to be undermining that stability; several OPEC countries (notably Saudi Arabia and Nigeria) are very important export markets for the UK,* and much of their import trade is regulated by contracts either directly or indirectly in the hands of the local Government and thus exposed to interference by that Government.

THE UK POSITION IN THE WORLD OIL MARKET

7. The UK is only a medium-sized producer and one which - in sharp contrast to the OPEC countries - has no centralised commercial control over production such as exists where decisions are all in the hands of a monopoly state oil company. The overhang of OPEC surplus capacity disproportionately exceeds any production cut we could make, and any unilateral move by the UK risks simply transferring benefit to OPEC countries without any change in the underlying market situation. In the end the threat to stability comes from OPEC not setting and observing a sufficiently restrictive set of production ceilings to enforce whatever price level is agreed. The UK - which runs a free market in oil - has necessarily stood aside from taking responsibility for price-fixing, which depends in the end on the Gulf producers who have the financial resources and volume of reserves necessary to take a long view. OPEC might no doubt like us to share with them the burden of production restraint, and might argue that unless we (and USSR and Norway) did this, prices would fall very sharply to our detriment. But there is a large element of bluff in this. OPEC has to defend its

* British commercial interests in Nigeria are greater than anyone else's - investment of about £2 bn, exports in 1983 worth about £750 m and total ECGD exposure of about £4 bn debt with payments of at least £750 m due or overdue in 1984.

prices whether we help them or not. And Saudi Arabia in particular appreciates that we cannot part company with the US and European Community in order to join an oil cartel of developing countries whose cohesion and behaviour are doubtfully reliable.

POSSIBLE MEASURES

8. It is clear from the position of the UK in the world oil market that the scope for UK initiatives designed to affect the world price of oil will inevitably be very limited. Measures which the UK could take to help maintain nominal prices or at least avoid appearing to precipitate a collapse fall into two groups:

(i) tactical measures on pricing and taxation which do not affect the balance of supply and demand but could persuade companies to continue for the time being to take oil from BNOC at a declared price of $30;

(ii) measures which directly affect supply or demand.

TACTICAL MEASURES

9. Annex I lists possible tactical measures. All have varying disadvantages. The measures to be used, if any, will need to be determined from day to day in the light of their costs, effectiveness and transparency which cannot be foreseen in advance. All are likely to increase the PSBR both directly through effects on BNOC's finances and indirectly through their effect on valuation of oil not sold at arms-length; but in practice these losses would be incurred to avoid larger losses in tax revenue from a collapse in prices.

MEASURES WHICH WOULD DIRECTLY AFFECT SUPPLY AND DEMAND

10. Annex II lists possible measures which the UK could take. Measures to increase stocks, or restrict North Sea out would be expensive. Unilateral action by the UK would have little effect on the balance of supply and demand though the change of policy it would represent could affect market sentiment. Any cut in UK production would be swamped by a small variation in the strictness

with which OPEC observed its own quota. A cut in UKCS production would only be effective in stabilising prices if it were itself the necessary and sufficient condition for the achievement of an OPEC agreement which thereafter was generally respected. Even then, the damage to the UK economy, both immediately and in its impact on the confidence needed for the continued development of high cost UK petroleum reserves could prove considerable; and once the UK had entered into mutual commitments with OPEC, it would be very difficult to disengage.

CONCLUSION

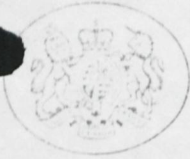
11. We therefore conclude:

(i) the balance of probability is that the marker price will be retained in nominal dollar terms for the coming year but there is a significant risk of a price collapse;

(ii) unilateral cuts in production by the UK would have little effect on the world balance of supply and demand (although they might affect market sentiment) but they would represent a major change in the Government's depletion policy which would damage the confidence of UK industry in North Sea development and would be costly;

(iii) to be effective any cuts in UKCS production would need to be co-ordinated with other producers, especially OPEC. This would entail a major re-adjustment of our traditional stance as a firm OECD/EC member and a "free market" producer;

(iv) such cuts would be worth considering only if they might clinch an OPEC production agreement at a time of collapsing prices in circumstances where the potential damage to the UK (and world) economy,



including the effects on our trade with and investment in OPEC countries, outweighed the domestic economic and political consequences of production cuts. Such circumstances appear unlikely;

(v) should major difficulties emerge consideration should be given in the first instance to the tactical measures in Annex I in order to persuade companies to take oil from BNOC at a declared price of $30, thus avoiding the appearance of initiating a fall in prices.

ANNEX I

TACTICAL MEASURES ON PRICES AND TAXATION

(i) Selective Discounts on Official Price. Probably more costly to BNOC than spot sales because they are likely to extend beyond the period of immediate market weakness. Discriminatory. If it became known would affect long term credibility of BNOC and HMG and attract OPEC reaction. Used in 1982.

(ii) Extended Credit. Would attract imitation from other producers but less politically sensitive than a price cut. BNOC would bear the extra credit cost. Would not help saleback customers.

(iii) Inclusion of Freight Costs within the Declared Price. Effect similar to that of discounts. In addition BNOC's chartering of tankers would be known and therefore the measures would be more transparent.

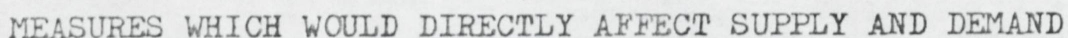
(iv) Saleback Based on UK Refinery Netback. Similar to OPEC practice and therefore less likely to attract reaction from them. Since it would have to be confined to UK refiners, it would probably breach the Treaty of Rome but might not become known. Calculation of the price would be complex and disputatious.

(v) Rearranging Differentials. By varying the discounts or premiums at which other UKCS crudes are sold relative to Brent blend, the UK marker crude. This trick was used last spring. Probably less scope second time round.

(vi) Backdating Prices. May be essential to allow time for market to clarify itself and OPEC to reorganise. This measure was also used last spring.

(vii) <u>Changing the Taxation System</u>. Modifying the system of valuation or other changes to the taxation system would require legislation and possible changes to BNOC's role. Such changes are currently being assessed in the BNOC Review; it is unlikely that changes could be made quickly and flexibly enough to affect the outcome of a crisis in the oil market.

ANNEX II



MEASURES WHICH WOULD DIRECTLY AFFECT SUPPLY AND DEMAND

(a) Increase Obligatory Stocks

1. HMG could directly increase world demand for internationally traded oil by increasing the UK's statutory stocking requirements and encouraging its European partners to do likewise. A report has recently been made to the Commission recommending an increase in strategic stocks. The UK has so far opposed its implementation. Even if the UK were to change its line, agreement could not be reached and a direction approved in time for the consequential stockbuild to affect demand in the first half of this year slthough widespread EEC support for such a measure might have a limited effect on market sentiment. Similar the statutory requirements for raising obligatory stocking levels in this country require procedures too lengthy to affect demand in that period. The oil industry would strongly resist such increases. An increase of 10 days in EEC stocks would raise crude oil demand over the year by 250,000 b/d at a capital cost of \$2.7 bn and annual storage costs of \$585 m (UK's share: \$480 m and \$100 m a year, respectively

(b) Hold Oil off the Market

2. The UK could reduce the amount of UKCS oil reaching the market, without affecting production levels, by storage. That would require tankers to be hired to take the oil. The costs of hiring tankers to take off the market 100,000 b/d for 3 months and store it for a further 3 months would be \$4 m. The financing of such storage would have to be undertaken by the public sector - revenue would of course be deferred and the oil might well in due course have to be sold at a loss. The operation would be highly visible and thus itself pose a threat to the stability of the market.

(c) Restrict UKCS Production

3. The Government has powers applicable to all licensees, to cut production. Fields now produce <u>either</u> under consents normally given every 3 or 6 months <u>or</u> in accordance with production programmes

approved by the Secretary of State for Energy. As regards the former, it would be possible for HMG to renew consents at reduced levels of production; as to the latter the licensing arrangements include procedures under which production can be constrained through the issue of limitation and further notices (at the time the programme is approved). But over the years, successive assurances have been given both in Parliament and elsewhere to licensees limiting the use of these powers to constrain production. These assurances are described in Annex III. In addition, licensees of some fields have received separate individual assurances.

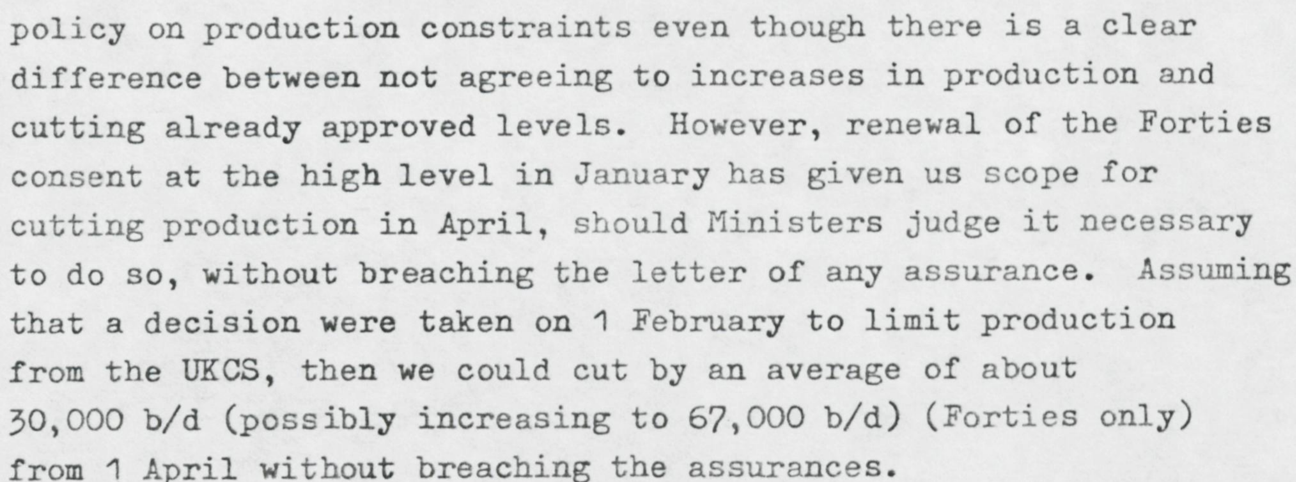
philosophy

4. The Government's general philosphy on depletion policy is that powers to control production would be used only in condition of extreme market crisis. Without such a situation and without careful preparation of the case with the licensees, use of the powers would severely undermine confidence in the UK's offshore regime. It would probably be resented by the industrialised countries who would accuse the UK of shoring up OPEC prices. It would also be expensive; each cut of 100,000 b/d would cost the Exchequer up to £700 m a year.* Nevertheless if Ministers were prepared to accept these disadvantages and to breach their more recent assurances then UKCS output could be reduced by an average of 250,000 b/d for 1984 as a whole but the actual reduction would fall mainly in the second half.

(d) Refuse Consent to Increased Production Levels

5. Production from one field, Forties, exceeds the approved profile by considerable amounts. Consent to the excess production has been given quarterly: and has now been renewed from 1 January. It would be possible both legally and consistently with the assurance not to cut production before 1 January 1985 to limit production from that field to the approved profile. We are unlikely to have technical reason not to renew the consent at its current high level from 1 April. Failure to renew at that level would kindle speculation that HMG was changing its

* (depending on the fields from which production is cut back)



policy on production constraints even though there is a clear difference between not agreeing to increases in production and cutting already approved levels. However, renewal of the Forties consent at the high level in January has given us scope for cutting production in April, should Ministers judge it necessary to do so, without breaching the letter of any assurance. Assuming that a decision were taken on 1 February to limit production from the UKCS, then we could cut by an average of about 30,000 b/d (possibly increasing to 67,000 b/d) (Forties only) from 1 April without breaching the assurances.

(e) Voluntary Production Constraints

6. Licensees might be persuaded that it was in their longer term commercial interests to reduce production. However voluntary agreement to reduction would not be forthcoming unless licensees believed that the additional value of the shut-in-oil when it was later produced would more than recompense them for the interest on the value of the production foregone. Moreover in some fields, the number of licensees and the undertakings they have given to raise finance make such voluntary reductions very unlikely unless the price of oil were to fall to, perhaps, $10-15.

(f) Storing Royalty-in-Kind Oil

7. HMG might store its royalty-in-kind by leaving it in the fields. That could not be done without the consent of the licensees. It would be complex both technically and in accounting terms to account for and recover it - indeed some might never be recovered. Recovery would require eventual compulsory production cuts. For each 100,000 b/d production reduced through such an approval, the loss in revenues would be nearly £750 m a year.

(g) Time Swap

8. Effects similar to a cut but without breaching the assurances might be achieved by a time swap with an OPEC country. In effect the UK would pay that country in 1984 to produce below its agreed quota; in 1985 the UK would cut production by more than the agreed

amount and be repaid by that OPEC country. But that would be difficult to account for unless the crude were of similar quality and value. Those OPEC countries with crude most similar to ours (e.g. Nigeria) also have precarious finances and could not be trusted to repay the revenues later.

Annex III

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ROYALTY (RELIEF) BILL: SECOND READING DEBATE

DEPLETION POLICY ASSURANCES

Background Note

1. The "Varley" assurances relating to the then Government's policy towards the control of the depletion of UK Continental Shelf oil, were made by Mr Varley when Secretary of State for Energy, on 6 December 1974. The assurances given were that:

(a) no delays would be imposed on the development of oil fields discovered at that time or on fields discovered up to the end of 1975 under licences which were then in force;

(b) no cuts would be made in production from such fields until 1982 at the earliest or until 4 years after the start of production, whichever was the later;

(c) no cuts would be made in production from any field found after 1975 under licences which were then existing until 150% of the capital investment in the field had been recovered;

(d) if depletion powers had later to be used, full regard would be had to the technical and commercial needs of the fields in question, which would generally limit cuts to 20% at most.

2. The present Government stated on 23 July 1980 that they would honour the assurances given by Mr Varley, on the basis of which heavy investment had been undertaken by the oil companies. The Government would however consider delaying the development of fields discovered after the end of 1975 which were not covered by the Varley assurances (and under this heading, the Clyde field was delayed for 2 years).

3. The 1980 statement left open the question of production cut-backs which the terms of the Varley assurances would permit the Government to apply in certain cases after the beginning of 1982. Mr Lawson announced on 8 June 1982 that such cut-backs would not be imposed at least until the end of 1984 in order to allow the oil industry a firmer basis for their exploration of and investment in the UK Continental Shelf. The Government would however ensure that the development of new and existing field proceeded on the basis of good oil field practice and that the wasteful flaring of gas was minimised. Also in 1982, the Government's reply to the report of the Select Committee on Energy on North Sea Oil Depletion Policy made clear in detail that the Government's policy remained as in the 1980 and June 1982 statements and that no economic case existed at present for imposing further delays on development. The Government would however retain such reserve powers of intervention as were available to it against the

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possibility of some substantial and unforeseen change in circumstances.

OIL 3A
4 July 1983

20 JAN 1984