Prime Minister (2)
To note, X and Y in particular
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MR TURNBULL 1 June 1984

THE OIL MARKET

Following John's note about banking and oil, I thought you should be brought up to date on the Gulf's impact on oil prices and supplies. So far the Gulf is still functioning quite well and there is no panic in oil markets.

Spot Prices

North Sea spot prices are at term levels while the Arabian light OPEC marker crude is trading at 50 cents per barrel below official prices. Although the increased tension in the Gulf has resulted in firmer prices than would otherwise have been the case, the market generally remains calm. Indeed, without the recent events in the Gulf we would be worrying about a potential price collapse.

Although the spot price would undoubtedly increase rapidly if the Straits of Hormuz were closed, the level and duration of the rise would depend on attutudes towards stocks and supplies. These perceptions will be conditioned by the initial reactions of governments, the IEA, other producing countries and the perceived willingness of consuming countries to draw on stocks. Provided that there are clear, immediate and credible statements of intent by all these parties, a closure of the Straits for even six months would be manageable.

The general feeling is that the Straits would only be closed for a short period of time. The market is generally reassured by the statements from President Reagan and is comforted by the 55-60 million barrels of oil which Saudi Arabia has in floating storage outside the Gulf.

Stocks

The trade figures for April do indicate a 5% increase in total UK stocks. On a wider scale, stock build-up in the IEA in April amounted to about 1%. However, the overall impression, confirmed by informal discussions with oil companies, is that the general approach is to refrain from reducing stocks further rather than a general policy to build up stocks. The companies have spent the last three years running down stocks in order to produce a better working capital position and they are reluctant to reverse this trend, except in response to events rather than expectations. Closure of the Straits of Hormuz has been billed many times before. The companies have made their contingency plans and remain generally relaxed.

Nevertheless, they are tending to buy further forward

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than normal with the emphasis on more secure sources of supply. However, this is only occurring for July oil and no company appears to be buying forward into August or September.

Traffic in the Gulf

There are conflicting reports about the extent to which the flow of tankers through the Gulf has been disrupted by recent events. Despite press reports that traffic is nearly at a standstill, information provided by posts and the companies seems to indicate that at a maximum traffic has been reduced by perhaps 20%. It is quite normal for there to be 30 tankers waiting outside the Gulf and press reports that this indicates an unwillingness to venture into the Gulf are misleading. The main problem is still in the north of the Gulf and tankers are moving quite freely in the south.

However, loadings at Kharg Island are significantly down. Estimates vary widely but the general impression is that between half to one million barrels per day were loaded last week compared with a normal level of 1.6 million barrels per day.

Conflicting information is also being received about loadings at Kuwait. Some posts indicate that these are proceeding normally whereas some company information indicates that loadings are perhaps down by as much as 50%. However, this is blamed more on insurance rates than on the risk of physical attack.

Fuel Oil Supplies

Oil burn is a vital part of the CEGB's endurance strategy. However, we would not expect the closure of the Straits of Hormuz to threaten this policy.

Current fuel oil supplies are split a third directly from neighbouring refineries, a third from term contracts and a third from the spot market. The oil companies have undertaken to continue direct and term deliveries on a "best endeavours" basis at Platts (market) related prices.

It will be important that the CEGB are in a position, if necessary, to withdraw from the spot market in the critical weeks following any closure of the Straits. In this context, they have now recently started buying forward on the spot market by 4-6 weeks on a fixed price basis - a very welcome development in view of the uncertainties. They are reluctant to become further exposed in terms of forward commitments, particularly in view of the uncertain duration of the miners' strike.

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The Board are also holding maximum oil stocks equivalent to about 2 weeks of total oil burn (ie nearer 6 weeks of spot purchases).

These two factors provide flexibility for the CEGB to withdraw from the spot market. If prices did remain high for an extended period the Government could allow the Board to draw on UK company stocks which could meet CEGB demand for 20 weeks.

This assumes that all fuel oil strategic stocks are allocated to the CEGB which could bring us under pressure both from other UK industry and internationally to reduce oil burn.

If the situation did become critical, we could always take wide-ranging powers under the Energy Act, 1976 to regulate supplies within the UK.

Conclusions

The oil market remains calm and there are no signs of panic. Spot prices are not above term prices. There is a modest build-up in stocks and an increasing tendency to buy further forward.

Closer examination of the situation in the Gulf supports the generally relaxed attitude being taken by the companies. Traffic through the Gulf appears not to be significantly reduced although loadings at Kharg Island are down. Providing the damage can be confined to the northern war zone the oil market reaction is the correct one.

If the Straits were closed, the immediate reaction of all parties concerned will be crucial in ensuring that price and the supply remains under control. Perceptions rather than realities will be determining. Although the spot price will undoubtedly jump if a crisis occurs, a prompt and credible response could limit the price and supply difficulties.

Y It is encouraging that very recent purchases of oil by the CEGB now gives them at least 2 months' endurance with maximum oil burn without any further purchases. All the time that tension in the Gulf remains, they should preserve a satisfactory stock and forward oil position.

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