Prime Minister (2)
Policy Unit are quietly saying "I told you so" over decision not to unload up BNOC. It is probably too soon to reopen this now but agree questions be asked when current phase of weakness is over?
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I assume SoS is in touch with Sheikh Yamani? Yes MS

MR TURNBULL

1 August 1984

THE OIL PRICE

The oil market is extremely weak and talk of crisis abounds. Spot prices of North Sea oil are now about $3.60 below BNOC's term prices and have fallen rapidly during the last two weeks. The Arabian Light marker crude is $2 below the official price.

BNOC are now having to dispose of 340,000 barrels per day onto the spot market at a daily loss of $1.2 million. Not surprisingly, the BNOC price is under extreme pressure.

How did we get here?

The market had always anticipated that the second quarter would be extremely difficult but that the situation would then become easier as demand picked up. However, the Iran/Iraq war more than compensated for any underlying weakness during the second quarter. Demand was also stronger as many companies built up stocks earlier than anticipated.

As a result the underlying weaknesses in the market were transferred into the third quarter although both OPEC and many market traders had assumed that the worst was over. The impact of the Iran/Iraq war has also been largely discounted and the market believes that supply interruptions are unlikely.

Discounting and over production remain major problems for OPEC. Production was probably running at about 18.5 million barrels per day (mbd) during June and about 18 mbd during July. This compares with the official quota of 17.5 mbd.

Iran has been able to use the excuse of war risk discounts and has effectively cut its price by about $2.50 a barrel. It is ironic that Nigeria, with probably the most severe economic problems, has largely remained true to official prices. As a result, they are not producing at their quota levels and are unlikely to do so without hefty discounts on a crude which competes directly with the North Sea.

The situation has not been helped by Saudi Arabia's oil-for-aircraft barter deal with Boeing and Rolls Royce. This is believed to involve 36 million barrels of crude oil which is coming onto the market during July and August. Consequently the market has had to absorb an extra 1 mbd at the height of Summer.

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This deal is also worrying on two further counts. It is the first time that the Saudis have adopted a barter approach which is almost certainly disguising some hidden discounting on the official oil price. It also appears to have taken place against the advice of Sheikh Yamani although there is no other reason to believe that Yamani's voice is not as influential as ever within the Royal Family.

The Prospects

It is still likely that demand will increase as we move into the fourth quarter. Although the confidence which OPEC displayed in Vienna in early July that output would rise to 19 mbd later in the year now looks misplaced, the current quota of 17.5 mbd and the marker price of $29 per barrel do look sustainable for the longer term. The stability of the oil market will therefore continue to depend upon the discipline within OPEC and in particular upon the role of Saudi Arabia, and on the state of the conflict between Iran and Iraq.

Sheikh Yamani has indicated privately that Saudi Arabia will act to reduce its own production and thereby restore confidence in the market.

The BNOC price

Once again BNOC has been placed in a totally inappropriate price leadership role with no room for manoeuvre. We cannot be seen to lead the world oil market down and we are therefore forced to defend a politically exposed BNOC price.

Meanwhile, the corporation is making heavy losses, the Inland Revenue are unable to use the BNOC price as a defensible tax reference price, and we are having to lean on the oil companies to accept a price which is not market determined. It is by no means certain that the companies will accept this pressure even with some of the inducements which Peter Walker is offering.

We continue to believe that the only long-term solution to these problems is the abolition of BNOC. As long as BNOC exists, we shall continue to come under the diplomatic spot light every time there is a weakness in the market. Without it, the market could smoothly adjust to changing conditions, as the US market does, without the Government ever being involved and without world oil stability being threatened.

In the meantime we have no alternative but to attempt to sustain the BNOC price for a limited period while we see

whether Saudi Arabia can reimpose discipline within OPEC. A collapsing oil market is in nobody's interest but it would be costly and probably ineffective for the UK to attempt to bolster the international oil price for an extended period. Furthermore, if BNOC did reduce its price now it would be extremely difficult to restore it in the fourth quarter when market conditions are firmer.

We should continue to avoid any suggestion of cutting UK production levels. If the position does not improve, we could consider our own limited forms of discounting, but in the end we shall have no alternative but to cut the price.

Conclusion

The key to the current weakness in the oil market lies with Saudi Arabia. If they reduce production and restore market confidence, the current official prices are sustainable through the fourth quarter and into next year.

In the meantime, we have no alternative but to support the current BNOC price of $30 per barrel, despite the losses which we are incurring and the pressures which we are having to put upon the oil companies.

This position is sustainable only for a strictly limited period, while Saudi Arabia is given a chance to restore market stability. If this does not happen, current BNOC losses are unacceptable. There is perhaps some limited scope for discounting but eventually we must reduce the price.

In the longer term we must reduce the political exposure of the BNOC price, preferably through the abolition of BNOC when market conditions allow.

DLP.

DAVID PASCALL

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