CONFIDENTIAL

CC / DP

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

22 August 1984

The Rt Hon Alick Buchanan-Smith MP
Minister of State
Department of Energy
Thames House South
Millbank
London SW1

NBPM

Dear Minister of State,

WORLD OIL MARKETS

You wrote to me on 15 August, setting out the measures you planned to take to reduce the pressure on BNOC.

I am prepared to agree to your proposals with one reservation. I am reluctant for you to enter into discussions with Shell on the lines suggested. Storing oil has few attractions and many drawbacks. However, I would not object if you thought it helpful to indicate to Shell that were they to produce specific proposals, we might be prepared to consider extended credit terms for storage at times of market weakness. But we must ensure Shell do not regard this as a commitment, since any decision to introduce such a scheme could only be taken in the particular circumstances of the time.

We have had to take decisions very quickly on this occasion. I think this underlines the need to keep the Treasury fully informed of developments in the oil market so that we are in a position to respond swiftly, and it goes without saying that it is helpful for us to have as much warning as possible of any proposal which might affect the level of oil prices.

I am copying this letter to the Prime Minister, Geoffrey Howe, Norman Tebbit and Sir Robert Armstrong.

Yours sincerely

Margaret O'Mara

NIGEL LAWSON

(approved by the Chancellor and signed in his absence)

315.27

Energy PT 2

World Oil Market

SECRET

cc AP

5

Foreign and Commonwealth Office

London SW1A 2AH

From The Minister of State

17 August 1984

DMB 17/8

Dear Chancellor of the Exchequer

WORLD OIL MARKET

Alick Buchanan-Smith copied to Geoffrey Howe his letter to you of 15 August outlining a number of measures which he proposes to negotiate with oil companies operating in the United Kingdom Continental Shelf with a view to persuading them to support the efforts of BNOC to hold its prices.

I agree that it is important in terms of our international relations that if a price cut does become inevitable we should be seen to have followed, not led, other oil producing countries.

There are two further comments I would make from the FCO perspective at this stage. I think we need to handle with great care any necessary interventions by the Government more directly with United Kingdom oil companies. Some parts of the press have already commented that our policy is moving closer to that of OPEC member states. The line we have been able to sustain hitherto - that the Government are not involved in market decisions and hence cannot be blamed for the decisions of BNOC or of the oil companies - has served us well. Were this policy to change we would be leaving ourselves open to criticism not only from oil importing countries, who would resent our obstructing a price cut but also, in the longer term, from OPEC countries, who would be able to point to one instance of intervention by HMG when urging us to take similar action in the future.

We need also to have in mind the possible danger of efforts to press the oil companies to adopt a common policy on prices or liftings being regarded in the United States as falling foul of anti-trust laws. We already have enough difficulty with the United States Government over the vexed

/question

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury

SECRET

question of extraterritorial jurisdiction not to wish to add a further set of problems to our commercial relationship.

I hope, therefore, that over the coming weeks there will be close consultation between Departments over the further handling of this problem.

I am sending copies of this letter to the Prime Minister, Norman Tebbit, Alick Buchanan-Smith and Sir Robert Armstrong.

Yours sincerely

Stewart [illegible]

for Baroness Young
(approved by the Minister
& signed in her absence)

Energy: Oil Prices Pt 2

SECRET

THE MINISTER OF STATE

Await Chancellor

DEPARTMENT OF ENERGY
THAMES HOUSE SOUTH
MILLBANK
LONDON SW1P 4QJ
Direct Line 01-211 3290
Switchboard 01-211 3000

4

The Chancellor of the Exchequer
Treasury
Parliament Street
LONDON
SW1P 3AG

15 August 1984

Dear Chancellor of the Exchequer

WORLD OIL MARKET

In the past fortnight, since Peter Walker wrote to you, spot prices have risen by some $2 though are still up to $1.50 below term prices. BNOC's financial position has eased significantly though its ability to maintain a sufficient volume of term sales remains under threat.

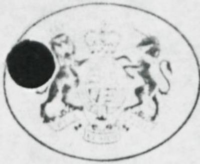
Some part of this strengthening no doubt follows our efforts to bring home to OPEC countries the serious weakness of the market and the need for them to act to strengthen market confidence. By taking steps to persuade companies to support BNOC's efforts to hold its prices, we have given OPEC countries sufficient time to put their house in order.

But the market remains fragile. We need therefore to continue to support the Corporation in its maintenance of prices: if a price cut does become inevitable, we should be seen to have followed, not led other oil producing countries. It is significant that there has still been no major cut in US posted prices, and some of the minor cuts made earlier have been rescinded.

We need therefore to continue to press oil companies not to put BNOC in such a position that it has to make a premature price cut. The interventions we have already made have raised the level of term business that BNOC has been able to keep this quarter from a threatened 29% to 38% of its disposals. There is a good prospect of increasing this to over 50% by persuading companies to accept the package outlined at Annex I. This package which is and has to be defensible on grounds of equity roughly apportions between companies a loss of about one third of the term quantities taken at the beginning of July.

Fortunately we have not had to offer expensive inducements of the kind that appeared might be needed at the time of Peter Walker's letter. The package would save HMG some $15-20m over the remainder of the quarter. There are, however, three elements in it which could have longer term consequences.

SECRET



Firstly our only possibility of procuring extra term purchases by Texaco (without which the package could fall apart as we could not so readily assure Esso of fair treatment) is by offering to allow them to retain the participation oil which they are currently contracted to sell to BNOC as a consequence of their take-over of Getty. This would not introduce a new principle into participation oil - Shell, Esso, Mobil, BP (for the bulk of its participation oil) and Texaco in respect of the rest of its production already have that right. In the short term it would further reduce BNOC's losses by reducing its avails. It is not possible to foresee the direct financial consequences in the longer term as those will depend on the relationship between BNOC's term price and the market price. But the Inland Revenue advises that it would not cut BNOC's freely disposable avails of the relevant grades of crude oil to levels below those at which the BNOC price would retain its evidential value in determining the price at which non-arms length disposals of those grades are taxed. On balance the arrangement would enhance security.

Allowing BP to retain Leg 2(b) oil on the same terms as Leg 2(a) oil raises similar questions to those raised by the Texaco element in the package. However we would propose to continue such an arrangement after the end of the year only if deeper consideration confirms its wisdom and BP still wishes to go down that route. In the short term again the proposal is to our financial advantage.

Thirdly Shell have proposed to increase their liftings from BNOC, but as part of an overall arrangement involving storing oil. The details of this which are set out at Annex II require careful thought. On the whole, while I see some considerable disadvantages in the scheme, I am inclined to think we should allow BNOC to explore the idea with Shell, entirely without commitment, so that the scheme could be put into operation fairly quickly should circumstances ever merit it. We do not have to decide immediately, but I should be grateful for your views.

Failure to pursue the package quickly could lead to companies withdrawing the offers they have already made. Also BNOC needs very quickly to work out with the companies its schedule of disposals in order to avoid demurrage charges (which could be heavy) or being forced to sell distress cargoes spot.

Over the next few days therefore, I, and BNOC where appropriate, will be negotiating the details of these arrangements with the companies concerned. Even if we are successful, BNOC will still have to sell a lot of oil at a loss on the spot market - perhaps over 400,000 b/d.

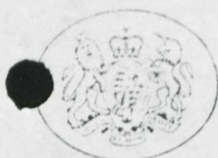
The costs of this to the country will, however, be very much less than the cost, monetary and political, of a premature price cut by BNOC.

I am sending copies of this letter to the Prime Minister, Geoffrey Howe, Norman Tebbit and Sir Robert Armstrong.

Yours Sincerely,

Sue Kellen.

ALICK BUCHANAN-SMITH
Approved by the
Minister of State
and signed in his
absence.



ANNEX I

PROPOSED PACKAGE

For the purposes of calculating the likely benefits of the proposals in this package, we have assumed that the measures run for all of August and September and that the spot/term differential remains at $1.50. Cost calculations assume the measures continue until the end of this Quarter and a spot price $1.50 below the BNOC price. The benefits represent savings to BNOC less any consequential tax losses assuming tax at the margin at 75-87.5%.

Esso

Accept reduction of term contract purchases from BNOC including royalty in kind purchases from around 130 kb/d to 85 kb/d. Promise to look again, including taking this up with other Departments, at possible measures to stop oil spinning but ensure Esso are under no illusions as to the difficulties of finding a cure that is not worse than the disease. Net saving to the public sector is $3.2 million.

BP

Accept offer of maintaining RIK purchases of 60 kb/d for remainder of the Quarter. Net benefit $5.5 million. In addition, accept BP's offer to retain the participation Leg 2(b) volumes (55 kb/d) on Leg 2(a) terms for the remainder of the year. This means that BNOC would save a further $5.0 million in the remainder of the Quarter although this would be partly offset by tax losses of $3.8-4.4 million, giving an additional net benefit of $0.6 to 1.2 m. Leave possibility of continuing revised Leg 2(b) arrangements after 1984 for further consideration. (Under BP's participation arrangements, BP currently retains some ¾ of the participation volumes - Leg 2(a) - and has an option to buy back the remainder - Leg 2(b) - at the BNOC price).

Shell

BNOC to pursue with Shell, without commitment, details of the scheme detailed in Annex II with a view to minimising the costs to HMG and possibly reducing/eliminating the storage element. Too early to assess total benefit, but could possibly result in an increase of up to 32.5 kb/d term sales; if there were no storage or other costs, the benefit would be $3.0 million.

Texaco

Offer retention of Getty saleback volumes (35 kb/d) in return for adequate purchases of BNOC oil. Aim to link Getty retention with Texaco maintaining term purchases. Getty retention would by itself give a net benefit to the public sector of $0.4 to 0.8 m. As negotiations have not been held, the likely quantity of additional term sales cannot yet be assessed. We should aim for 30 kb/d for the remainder of the Quarter. This would be worth $2.7 million giving a total benefit of $3.5 million for the whole package. In the longer term, the financial effect of the Getty deal depends on the future relationship between spot, term and tax valuation prices.

Conoco

Press for an increase in their term contract (formerly 45 kb/d) from 15 kb/d to 25 kb/d. If successful, this would save the public sector $0.9 million.

Total

Firm up existing offer of 15 kb/d term purchases from Total (GB) to cover September as well as August and seek a further 5 kb/d term purchases from CFP, the parent company. Saving, if achieved, would be 15 kb/d or $1.4 million.

Mobil

Accept offer to maintain liftings of 15 kb/d at term prices, but firm up price review provision so that retrospective price changes would only occur if the BNOC price was changed during the quarter. Saving would be $1.4 million.

Petrofina

Petrofina has agreed to maintain liftings at 12 kb/d instead of the total phase out it was threatening. It refuses to offer higher liftings. Saving achieved is $1.1 million.

Overall savings from the package range from $15-20 million.

Effects of the Package on BNOC

The change in BNOC's term/spot mix as a result of offers so far made by companies in response to our requests and of the package, if we achieve it, is shown by this table:

	BNOC Disposals				'000 b/d
	Term	%	Spot	%	Total
Position on 1 July	682	77	208	23	890
Threatened position on 1 August	265	29	641	71	906
Position at end August (already) achieved	340	38	566	62	906
Position at end August if package achieved					
(without BP taking Leg 2(b))	462	53	409	47	871
(with BP taking Leg 2(b))	462	57	354	43	816

ANNEX II

SHELL'S PROPOSAL FOR REMOVING VOLUMES OF CRUDE FROM THE MARKET

1. Shell have proposed to purchase two tranches of oil from BNOC: 32,500 b/d at full term prices, and a further 32,500 at spot prices. Both tranches would be stored on land at refineries for a period of 60-90 days, effectively removing some 65,000 b/d from the market in an attempt to strengthen the market.

2. The overall effect of the Shell proposal as it stands, is likely to be more costly to BNOC than for the Corporation to continue to undertake spot sales. That is because Shell have asked for a fairly high storage fee - 35¢ bbl - together with extended credit to cover the storage period - an additional 60-90 days credit. Removing 65,000 b/d temporarily from the market is unlikely to have more than a marginal effect in increasing market stability. Indeed, the impact on the market needs careful assessment: volumes of oil in storage appearing to overhang the market could destabilise rather than stabilise it. Furthermore, removing volumes of oil from the market could set an unwelcome precedent, leaving us open to pressure from OPEC countries to repeat the exercise in every subsequent period of weakness.

3. However, it may be possible to amend the proposal so that whether or not the volumes are stored is a matter for Shell's commercial judgement. Then the proposal becomes closer to a straight sale to the company, at a price better than prevailing spot prices, but possibly lower than term prices. If a workable scheme is drawn up, it could be brought into operation quickly; in some circumstances, particularly if the market weakens again, it may be more advantageous for BNOC to implement a revised Shell storage scheme than to continue spot sales. At this stage however, negotiations should continue without commitments.