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AT
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CCNO

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

9 October 1984

The Rt. Hon. Peter Walker MBE MP
Secretary of State for Energy

Dear Peter

**BNOC PRICES**

I have now had a chance to consider your letter of 21 September, which arrived while I was in Washington.

Given the importance of North Sea oil prices to the economy, the PSBR and public expenditure, I am sorry that you did not, as is usual, consult the Treasury before taking your decision on BNOC's fourth quarter prices.

In the event I was quite content with the decision taken. But I should take this opportunity to record my concern about the mounting public expenditure cost of continuing to keep the BNOC price well above the market price. We clearly cannot allow this to go on for very much longer; and I am sure you have it in mind to bring proposals forward soon.

I am sending copies of this letter to the Prime Minister and Geoffrey Howe.

Yours
Nigel

NIGEL LAWSON

Energy Pt 2

Oil Prices

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cc: NAT IND: Govt Electricity

24 September 1984

MR TURNBULL

BNOC PRICES

We agree with the analysis set out in Peter Walker's letter to the Chancellor.

The agonising over price differentials and BNOC's term custom just underlines the undesirability of keeping BNOC in its current form.

The Prime Minister might write approving the approach and reminding Energy of the need to examine BNOC's future again in the light of recent problems.

ELECTRICITY: NEXT FINANCIAL TARGET

Peter Walker's letter on this subject also has considerable justice in it. The replacement cost of assets in an industry as over-provided with plant as the electricity industry is a very academic concept.

What matters politically is:

a. a reasonable level of price increase for electricity, so that we do not incur the disopprobrium of back-door taxation;

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b. an effective means of applying pressure to the cost base of the industry, so that more profit and more cash flow can be generated for the public sector for a given level of revenue;

c. the Treasury are not undermined in their energy bilateral which is seeking substantial cash benefits from the electricity EFL.

The debate concerning all of the nationalised monopolies, including electricity, gas and water, should concentrate on the systems in place for enforcing detailed unit costings, for exerting pressure for greater economies of scale to be delivered, more asset sales, and better control of working capital.

JOHN REDWOOD

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Prime Minister (2)
Mr Walker has persuaded BNOC not to cut its prices by $1 per barrel. Though this means losses for BNOC this is made up for the Exchequer by extra tax revenue
AT 21/9

SECRETARY OF STATE FOR ENERGY
THAMES HOUSE SOUTH
MILLBANK LONDON SW1P 4QJ
01 211 6402

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

21 September 1984

Dear Nigel

OIL PRICES

Following my recent agreement with the Chief Secretary about BNOC financing, I am writing to you about the Corporation's pricing policy for the 4th Quarter. I have sought the views of Shell, Esso, BP, Texaco and Mobil on the likely development of the market over the next 3 months.

There is a wide range of agreement amongst the major integrated oil companies, although Mobil have a somewhat more pessimistic assessment of the market than the other 4 companies. First, there is widespread agreement that the supply sides of the large oil companies are taking a much shorter term view than even a few months ago. Rather than taking, say, a 3 month view they are looking only 2 or 3 weeks ahead. Secondly, they agree that, because of this shortening of horizons and because Europe is now receiving the over-production from the Gulf in July, the market is weaker than fundamentals would justify. Normally companies would now be stocking up for the winter. They are in fact destocking. Thirdly, the companies other than Mobil expect a marked tightening of the market sime time during the next 4-6 weeks. Market perceptions that the winter is upon us and that supplies are unusually low could arise very rapidly with consequential effects on spot prices. Of course, if OPEC were to grant themselves increased quotas next week, these forecasts of hardening prices might not materialise.

Several companies, notably Shell, Esso and BNOC, have also drawn attention to a long term reduction in the market value of lighter crudes compared with the heavier Gulf crudes. The majors, however, notably Shell, Esso and BP, have strongly recommended against a technical reduction of the BNOC term price now. While the oil market is considerably stronger than in July (to the great benefit of the Exchequer) it is still fragile. The companies argue that a cut in the BNOC price now will run a high risk of destabilising the world oil market with adverse effects not only on oil prices but also on sterling and on our relations with OPEC countries. They see such an adjustment as particularly imprudent at a time, when other things being equal, one would expect to see an early strengthening of the market.

I see considerable force in this analysis by the major oil companies.

The BNOC Board delayed making a recommendation on 4th Quarter prices until 19 September, although contractually their prices should have been announced on 14 September. They recommended a $1 cut largely to reflect the change in differentials referred to in paragraph 3 above. In doing so, the Board was naturally concerned by their own financial prospects and the need to maintain their term customers in the current difficult market position.

I have discussed this recommendation with Douglas Croham and Ian Goskirk, both of whom accept that the Government might wish to override their Board's recommendation for wider reasons. They did however stress that any delay at this stage could trigger off market rumours such as contributed to the weakness in July.

I believe we would be quite wrong to agree to a cut of $1 in the Brent marker at this juncture. It will incur unnecessarily high risks of destabilising the world oil market just before it is likely to tighten. I accept that asking BNOC to hold their term price will involve them in some further loss of term custom and in further financial losses over the next few weeks. But, so long as BNOC can continue to sell some 20% of its freely tradeable oil at term prices, the gain in tax revenue will outweigh BNOC's losses. There will consequently be a net gain to the PSBR. We also need to take into account the reactions of OPEC countries, to what they would undoubtedly judge an ill-timed and unnecessary price cut and the effects on sterling.

I believe our officials should continue to monitor the position closely. I have asked my officials to give fuller consideration to the optimum way of dealing with the problem of changed differentials. Unless that problem is resolved, BNOC will find it difficult to retain any significant term custom in the longer run. I am convinced, however, that the right time to contemplate any technical change is when the market is harder. A change then is likely to run the least dangers of upsetting the market and provoking retaliatory action from OPEC Governments.

In view of the need to avoid uncertainty, I have told Douglas Croham that BNOC should maintain their current term prices, and they will be telexing their customers and suppliers this evening.

I am sending copies of this letter to the Prime Minister and Sir Geoffrey Howe.

PETER WALKER

ENERGY: Oil Markets
Pt 2

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Foreign and Commonwealth Office

London SW1A 2AH

From The Minister of State

28 September 1984

OIL PRICES

You sent Geoffrey Howe, who is as you know in San Jose, a copy of your letter to Nigel Lawson of 21 September about BNOC's fourth quarter pricing.

You mention possible technical changes in setting prices for UKCS crudes. Any such changes would of course have implications for our relations with other oil producers and I should be grateful if our officials could keep in close touch about this.

I am sending copies of this letter to the Prime Minister and the Chancellor of the Exchequer.

Baroness Young

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy

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ENERGY: Oil Prices Pt 2 Pt 2