7.60

Prime Minister (2)

Following this afternoon's discussion, the Chancellor has lost patience with Mr Walker. To await Mr Walker's response

AT 11/12

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

11 December 1984

The Rt Hon Peter Walker MBE MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
LONDON SW1

Dear Secretary of State,

BNOC: OIL PRICES

Since we agreed in October to the cut in BNOC prices, there has been a further significant weakening of the oil market. We now face another delicate decision in setting BNOC's prices for the next quarter. We discussed this earlier today.

I am concerned about two aspects of this position. First, as long as spot prices are below the BNOC price, BNOC will make losses. As I understand it, at present price relativities, BNOC is now entering into commitments which are building up losses at a rate of over $1 million a day. This adds to public expenditure.

We have in the past been willing to see this happen for short periods rather than respond to volatile movements in the market. There seems little reason to believe that the oil market will be any stronger in coming months.

This brings me to my second concern. If we continue with our present quarterly administrative price fixing, we will find ourselves having to tackle further downward adjustments to BNOC prices. This attracts diplomatic and economic pressure we could well do without.

In your letter of 17 October, you raised the possibility of moving to a flexible market related pricing system using a formula based on spot prices. This would enable BNOC to keep its prices more closely in line with the market, and so prevent it incurring large-scale losses. It should also obviate the need for us to take regular pricing decisions, and so reduce the diplomatic and economic pressures on us. I understand that BNOC now favour this approach.

Obviously the timing of any move of this sort requires very careful judgement. But it is vital that the new arrangements are in place with effect from 1 January 1985.

There is a particularly difficult tactical judgement in relation to the OPEC meeting on 19-20 December. In my view it is desirable that BNOC announces its intentions ahead of that meeting so that OPEC take their decisions in full knowledge of BNOC's move. If they take their decisons first, and then BNOC change course, the market will have little faith in the OPEC outcome (since it will have been overtaken by events) and the Saudis are likely to feel that we have let them down. So I think we should move now.

I am copying this letter to the Prime Minister and Geoffrey Howe.

Yours sincerely

JL clerk

pp NIGEL LAWSON

(Approved by the Chancellor, and signed in his absence)

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MR TURNBULL

12 December 1984

BNOC: OIL PRICES

As the Chancellor points out in his letter of 11 December to Peter Walker, the timing of a move by BNOC to formula pricing is a particularly difficult tactical judgement in relation to the OPEC meeting on 19-20 December. He concludes that it is desirable for BNOC to announce its intentions ahead of that meeting so that OPEC can take their decisions in the full knowledge of BNOC's move.

We should be wary of endorsing that conclusion. Rather than seeing an early move by BNOC as unpalatable, but nonetheless an act of fair play, Yamani and the principal OPEC Ministers are more likely to see it as an act of provocation which undermines the basis of their meeting.

The forthcoming OPEC meeting has been convened to tackle the long-outstanding problem of outdated price differentials between crudes of different quality. Yamani has been chairing a sub-committee to prepare the ground for this. The only hope of a re-alignment of differentials is upwards relative to the Saudi marker price. That can only be achieved in a hard market. Saudi Arabia has been striving towards a hardening of the market by reducing its oil production from 5.3 million b/d in the first quarter of 1984, to 3.8 million b/d now. The rest of OPEC have been surprisingly disciplined and supportive, at least on volume controls. The mild northern

Winter has not helped them, nor has the increase of UK North Sea production from 2.4 million b/d in the Summer to 2.6 million b/d now.

With the oil market still unfavourably weak and nervous, Yamani and his sub-committee already face a daunting task at their meeting next week. Against that background, a prior statement of a change of pricing policy by BNOC would probably be perceived as a body blow.

Taken, say, two weeks or more after the OPEC meeting it could at least be presented as a vote of confidence in OPEC's continuing efforts to maintain price stability. In any case, we shouldn't rule out the possibility of a sharp hardening of the market around the end of the year. Stocks are exceptionally low. A cold snap could send oil buyers rushing into the market.

JW

JOHN WYBREW

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CC/NO

01 211 6402

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

14 December 1984

Dear Nigel

— WHAT?

BNOC: OIL PRICES

I have received your letter of 11 December. We have consistently taken the position, both while you were Secretary of State for Energy and since, that BNOC are price followers and not price leaders. I believe that it would be the height of folly to reverse this basic tenet of our policy at this particular juncture. Whatever approach we decide to adopt to BNOC's future pricing, I am sure that we should only decide and announce this after the OPEC meeting on 19 December. In any case there is not enough time to complete all the necessary consultations before the OPEC meeting.

As Alick Buchanan-Smith pointed out to the Select Committee on Energy yesterday evening, there are a number of very important uncertainties at the moment, which would make an immediate decision most imprudent. I have already mentioned the OPEC meeting, which will consider not only prices and quotas, but the key question of differentials. Secondly, we need to evaluate Statoil's reported decision not to set a term price for December sales, which was announced yesterday. Thirdly, you will no doubt have seen Peter Baxendell's remarks about the likelihood of the market position being changed very significantly before the end of a year, when he is forecasting a bear squeeze on oil prices - you will recall that last year the market only hardened in late December. Whatever is decided about BNOC's price beyond the end of the year, it is highly desirable, if at all possible, that any announcement should be made against the background of a hardening market and not in the present uncertain conditions.

I imagine that your letter was written before you had had time to consider Yamani's remarks reported in yesterday's newspapers. I believe these must be taken very seriously. Even if we are eventually forced to announce unpalatable decisions, it is surely only commonsense to do so when we are in a position to point to the inadequacy of OPEC's own performance.

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In short, I believe we should continue to consider all the options, but only aim to reach decisions and allow BNOC to make announcements right at the end of the year. I take your point about public expenditure, but the public expenditure risks are totally dwarfed by the risk to your revenue if, by leading the market, we should push down prices gratuitously. And, as you know, some 80% of the public expenditure is anyway recovered in tax from the oil companies.

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

Peter

PETER WALKER

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