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AT 2/11
PRIME MINISTER

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BNOC

UK oil production licences give BNOC the right to buy 51 per cent of the licensee's oil availability at the official(?) price. The availability is less than total production, because it has been advantageous for the Government to exercise its right to take 12.5 per cent of the oil as royalty in kind. (BNOC acts as the Government's agent in selling this oil - in 1985 about 290,000 barrels per day.)

The participation agreements negotiated between BNOC and the licensees under the Labour Government do not all follow the same model. The big companies like Shell, Esso and - to some extent, we believe - BP, were able to negotiate a buy-back arrangement whereby they effectively retain their oil. Thus, in 1985, BNOC's foreseen oil availability would be:

- Royalty oil handled on behalf of HMG 290,000 b/d
 - Participation oil purchased at official price 430,000 b/d
 - Purchases from minor producers (without trading organisations) at official price 50,000 b/d
- 770,000 b/d

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The principle behind the participation agreements was that BNOC would pay the producers a fair market price. Of late, however, BNOC has got itself marooned between the strategic pressures to support OPEC's official oil price structure and the market pressures reflected in the spot market. Thus, BNOC is having to pay the producers the official price of \$28.65 per barrel, whereas virtually all the oil now has to be sold at spot prices (currently \$26.25 per barrel). In consequence, BNOC is currently losing £1 million a day, although £800,000 is recouped in high^{er} taxes from the producers.

Much as we might wish it otherwise with oil markets nervous and looking for signals, BNOC cannot escape the spotlight. The UK is, after all, currently the world's fifth largest oil producer:

-	USSR	12m.b/d (of which 1.5-2.0 million b/d exported)
-	US	8.7m. b/d
-	Saudi Arabia	3.5m. b/d
-	Mexico	3.0m. b/d
-	UK	2.7m.b/d

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So far, reactions to the December OPEC meetings have been adverse. Oil traders have given OPEC the thumbs down, maintaining that not enough has been done to contain the downward pressure on oil prices. Everyone is nervous and unwilling to buy oil for fear that prices will fall, perhaps sharply. Around the Arabian Gulf, there is a stand-off, with total OPEC production currently understood to be down to an exceptionally low 15m. b/d.

The gloomy scenario says that a downward price move by the UK, whether a discretionary adjustment or a decision to track the spot market, would:

- force Nigeria (and probably Algeria and Libya) to follow suit;
- make Yamani decide that he is at the end of his tether in trying to manage the market via cohesive OPEC discipline, and conclude that the only option is shock treatment - a severe downward price move.

We are working with DEn. officials on an analysis of the options and the associated risks. There are three measures which can be taken, probably in the order set out below:

1. Avoid a vote of no confidence in OPEC - and, above all, Yamani - by maintaining BNOC's official price at \$28.65 per barrel for the time being, but reduce BNOC's losses

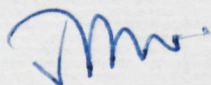
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by winding down the participation contracts (speeded up with the voluntary support of the oil companies.)

2. Move to formula pricing, whereby BNOC tracks the spot market (preferably starting on a rising spot market and not, as now, when BNOC is the last check against a downward price spiral).
3. Abolish BNOC.

The effect of the current cold snap on a world oil supply system, with stocks approaching minimum levels, is the wild card.



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