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

28 January 1985

Tim Flesher Esq
10 Downing Street
LONDON SW1

Dear Tim,

I attach briefing as requested on the impact on Government revenues of a one dollar fall in the oil price. This has been approved by the Chancellor. He feels it is especially important to see the rise in the sterling oil price on page 2.

Yours sincerely,

Philip Wynn Owen.

P WYNN OWEN
Assistant Private Secretary

UK AND WORLD OIL MARKET

FACTUAL BACKGROUND

WORLD SCENE

1. PRODUCTION

	PRODUCTION 4Q/1984 million barrels/day	NET EXPORTS
USSR	12.3	1.5
USA	8.8	-
Saudi Arabia	3.8	3.3
Mexico	2.9	1.5
UK	2.6	0.6
China	2.2	0.5
Iran	2.2	1.5
Other OPEC	10.7	7.6
Other non OPEC	10.2	-

2. DEMAND

	4Q/1984 million barrels/day
Communist Bloc	13.4
USA	15.8
W Europe (Excl. UK)	10.5
UK	2.0
Japan	4.7
Rest of the world	10.3

3. OPEC

Country	Quota	Estimated current production
Saudi Arabia	4.353	3.8
Iran	2.3	2.0
Iraq	1.2	1.2
Kuwait	0.9	1.0

Country	Quota	Estimated current production
UAE	0.95	1.0
Qatar	0.28	0.3
Venezuela	1.555	1.65
Nigeria	1.3	1.65
Libya	0.9	1.1
Indonesia	1.189	1.3
Algeria	0.663	0.6
Gabon	0.137	0.2
Ecuador	0.183	0.3
Total	16.0	16.1

4. OPEC DECEMBER MEETING

(1) Confirmed production programme of 16 mb/d. (Actual production, we believe, for December: 16.7 mb/d).

(2) Established new Audit Committee under Yamani which is charged with arranging for the independent audit of each country's production and prices.

(3) Agreed changes in price differentials: increasing price of heavy crudes by 50 ¢/barrel and of medium by 25 ¢/barrel; reducing price of very light crudes by 25 ¢/barrel (these will include UAE, African and, by extension, North Sea crudes), but maintaining price of OPEC marker, Arabia Light, at $29.

Nigeria, Algeria and Libya refused to accept (3) and UAE very restive. Further meeting on prices and differentials planned for late January.

5. PRICES. Current official and spot prices for some main crude grades are

	($ per barrel)	
	GSP	Spot
Saudi Heavy	26.50	26.50
Saudi Light	29.00	27.85
Nigeria Forcados	27.50	26.35
Brent Blend	28.65	26.55

All UKCS oil and probably some 60% of OPEC oil now moves at or near spot prices. The attached graph compares the movement of Brent spot prices and the value at the refinery gate of products made from Brent blend with the BNOC price.

BNOC

6. SUPPLIES. BNOC's sources of supply are:

	'000 b/d	
Royalty-in-kind	280	BNOC acts as HMG's agent. No financial risk to BNOC.
Participation saleback	540	BNOC resells to the licensee at the same price as it purchases. No financial risk to BNOC.
Other participation	480	BNOC at financial risk.
Other purchases (contracted)	100	BNOC at financial risk.
Total	1400	

7. Under the participation agreements, BNOC normally has to exercise an option to purchase the crude 6 months before it takes effect. It then normally last for a year but in some cases the option lasts longer. Consequently, BNOC could not escape from taking an

individual licensee's oil until between 12 and 18 months after it had decided not to exercise an option. Under most options it buys 51% of the licensees production. The table below shows how fast BNOC's participation avails and other purchases could be run down if licensees held BNOC to its contractual obligation:

	'000 b/d BNOC's supplies at financial risk
1/1/85	540
1/7/85	520
1/1/86	250
1/7/86	160

Thereafter gradually diminishing.

8. However, with the agreement of the licensee, BNOC could legally run down its availabilities very much faster. We believe that agreement could be reached with enough licensees for BNOC to shed between 50% and 75% (perhaps more) of its supplies at financial risk within 4-8 weeks.

9. PURCHASE PRICES. Under the Participation Agreements, BNOC is obliged to pay a "market price" to its suppliers which is frequently expressed as the term price. Recently the term price has been well above the true market price. Until the end of December BNOC paid its suppliers $28.65 per barrel for Brent Blend - the prices of other North Sea grades vary slightly around that price. Before Christmas, BNOC informed its suppliers that it would defer proposing a price for 1985 First Quarter sales until January and would then seek to backdate it. It has not yet made a proposal. Accordingly the price of BNOC's current supplies has not been fixed.

10. SALES AND SALE PRICES. All of BNOC's non-saleback oil is now sold at spot prices. About half of it is sold on a term basis (but at spot related prices) to a handful of customers, the largest of which are Esso, Shell and BP. The rest is sold directly on to the spot market. BNOC normally sells the oil available to it at least one month in advance. Thus it has sold all its January avails and is currently selling its February avails.

FINANCIAL EFFECTS

11. As BNOC has not yet agreed or even proposed, its term prices for January, it is impossible to say what, if any, its daily losses will be. If its retroactive price to its suppliers is based on realisations, its losses will be nil. If based on a formula, it may make a small profit depending on the exact terms it can negotiate. On the other hand, if it maintains its term price of $28.65, it will be losing £700,000 per day* in January, increasing to about £1 m per day** thereafter. However the Inland REvenue confirms that some 80% of this sum is clawed back through the tax system. The net monthly loss to the Exchequer is therefore some £3.4 m in January and £6 m per month thereafter.

12. Up to the end of December, BNOC's losses since July were some £33 m; its reserves at the end of the year were £2½ m before grant. It has now been paid an initial tranche of grant of £20 m. As mentioned, the scale of losses after 1 January depends on future decisions about the price BNOC pays suppliers. If the $28.65 term price is maintained, the £45 m already

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* 420,000 b/d at loss of $1.35 per barrel and 160,000 b/d at loss of $1.00 per barrel.

** 420,000 b/d at loss of $2.00 per barrel.
100,000 b/d at loss of $1.60 per barrel.
£ = $1.15

voted can cover BNOC's losses until the end of this month while maintaining BNOC's reserves above the £30 m with which it was originally endowed. But, unless a new provision for grant is made (or prices change) BNOC's reserves would reach nil during the first week of March. It would not, though, go into cash deficit until the beginning of April.

13. If BNOC were to move to a formula pricing system, its price would decline from $28.65 in December to $27.10 in January and (on the evidence so far this month) about $26.50 in February. For each drop of a dollar in the price of oil, the loss of tax revenue is £500 m in the first year and £640 m in subsequent years. However a decline in the price of oil is also likely to affect sterling parity. For each decline of 10 ¢ in the value of the pound, tax revenue increases by £1.25 bn per year. These figures really apply only for small changes. Major changes would have additional effects. For example, if oil prices declined below a certain level, UKCS taxation might have to be relaxed.

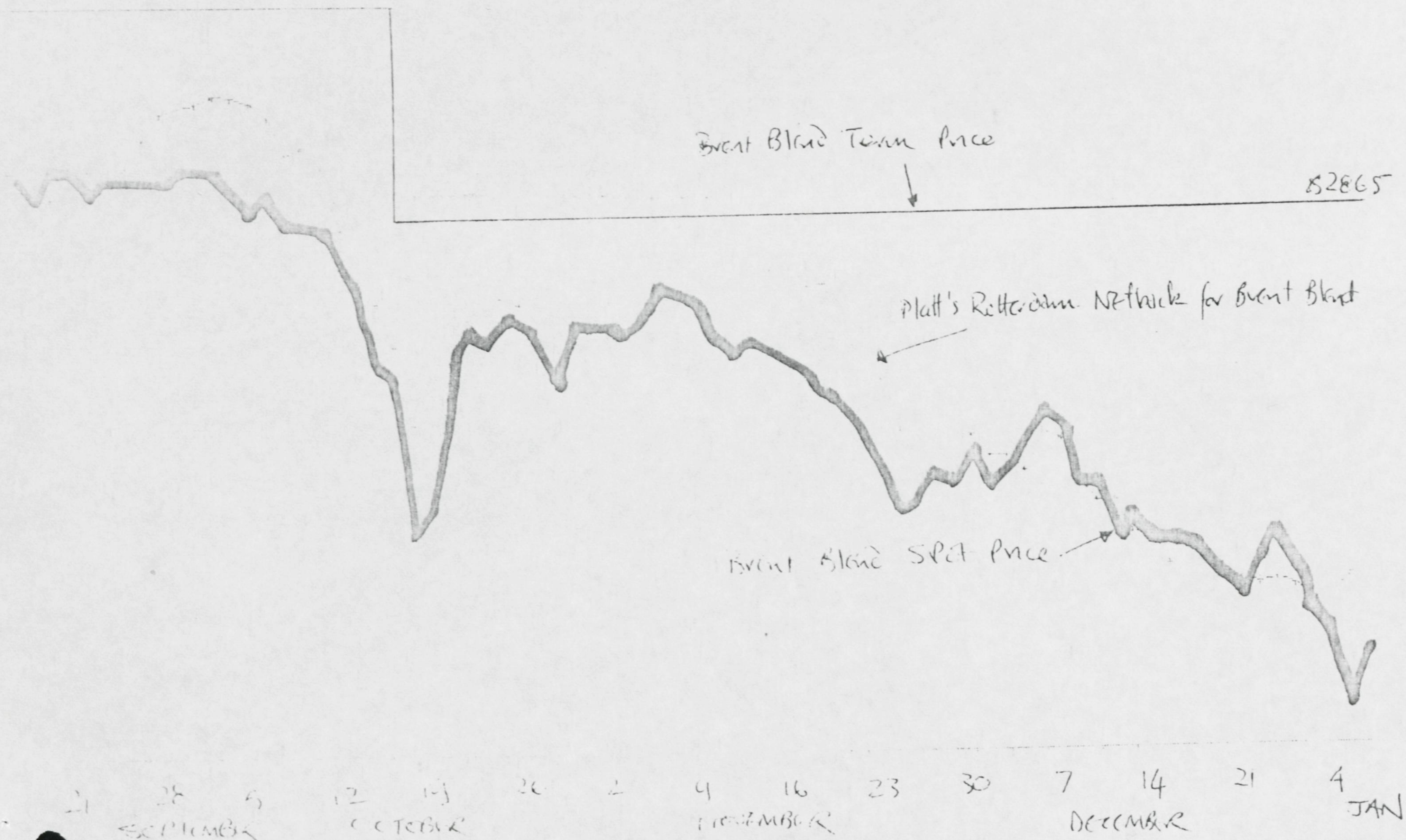
DEPLETION POSSIBILITIES

14. We have powers to control production. Taking account only of the legal constraints, we could theoretically make cuts in

67% of UKCS production from 1 July 1985
75% " " " 1 January 1986.

15. But certain of the Varley assurances still have force. Within those assurances we could reduce overall North Sea production by about 13% from 1 July 1985.

Brent Blend Spot Prices



15-16 m.b.d. ...

14

Cut production?

2.1 m.b.d.

Prod^n start falling.

1/2 day to see

B.N.O.C. - bad

published [illegible]

Nigeria

Nigerian Scene

Undercut.

Minister

B.N.O.C

+ O.P.E.C.

27.30.

28.50

27.50

28.50