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c. Master Set

10 DOWNING STREET

8 February 1985

From the Private Secretary

Dear Michael

BNOC AND OIL PRICES

The Prime Minister held a meeting today to discuss developments in the oil market. Present were the Foreign Secretary, the Chancellor of the Exchequer and the Secretary of State for Energy. The Prime Minister summarised the points which had emerged from the various discussions that had taken place during the course of the week.

First, it was clear that OPEC would react sharply to an announcement by BNOC that it was setting its January price at the average of realisations in the month, with the price for February and March being set at the previous official price. They would regard the lower price for January as providing a discount. Secondly, OPEC did not object to a reduction in BNOC's participation agreements. They appeared to recognise the argument that, by offering higher prices, BNOC was actually encouraging production. Thirdly, it was agreed that the Government should take its royalty oil in cash rather than in kind. Fourthly, OPEC were arguing that excessive liftings could damage reservoirs and that, in consequence, it would not be difficult to persuade the oil companies to reduce their North Sea production. Finally, OPEC had reported the view of the Mexican Government that it could sustain a $1 per barrel fall in the price but that a $3 fall would damage the financial stability of the country which in turn would damage the US banking system.

In discussion, it was agreed that care should be taken in interpreting a number of these arguments as they clearly reflected OPEC self-interest. Nevertheless, although OPEC's view of a lower BNOC price for January was irrational (since what was at issue was a reduction in the buying price and BNOC was already selling at lower prices) the likelihood of retaliatory action had to be taken seriously. It was not necessary for BNOC to commit itself immediately to a price for March. The opportunity to scale down BNOC participation agreements should be taken; this could be a step towards the eventual winding up of BNOC. The Petroleum Bill proposed for the next session could provide a legislative vehicle for this as well as for introducing a mechanism which would allow the transition from royalty in kind to royalty in cash to be effected without a cash flow loss to the Government.

Summing up the discussion, the Prime Minister said BNOC should set its prices for January and February at the previous level. She invited the Secretary of State for

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Energy to prepare a paper setting out proposals for BNOC's withdrawal from participation contracts; considering whether the Petroleum Bill should provide for the winding up of BNOC; and examining how a move to royalty in cash could be achieved without a cash flow cost. The group should meet again when the paper was ready.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and Rachel Lomax (HM Treasury). I would be grateful if it could be shown only to those who strictly need to know if its contents.

Yours sincerely

Andrew Turnbull

(Andrew Turnbull)

Michael Reidy Esq
Department of Energy