MR NORGROVE 10 December 1985

THE OIL MARKET

Two months ago, Saudi Arabia abandoned its role as OPEC's swing producer, changed its pricing policy and boosted production from 2 to 4 million b/d - close to is nominal share of OPEC's official production ceiling of 16 million b/d.

Against that background, it was inevitable that the outcome of last weekend's OPEC meeting would be confused, with conflicting signals from the principal factions. One group (including Algeria, Iran, Libya and Venezuela) shudders at the prospect of taking on non-OPEC producers in an oil price war, sees little prospect of inducing non-OPEC producers to collaborate in defending high oil prices, and wants OPEC members to go on exercising production restraint. The other wing, now with the notable inclusion of Saudi Arabia, wants to raise the stakes and play a more risky hand, albeit with the same objective of maintaining stable, high oil prices.

The key figure in this war of nerves is Saudi Arabia which, significantly, has distanced itself from the new OPEC committee charged with finding a solution. The latest reading from well-informed oil industry sources, suggests that the Saudis are now persuaded that OPEC alone can no longer cope on a lasting basis. Oil demand is too slack and non-OPEC production too buoyant. Yamani has a new remit from the Royal Family; Saudi Arabia will not throttle back its 4 million b/d

production until the oil price is low enough to induce the non-OPEC producers, notably the UK, to collaborate with OPEC in defending stable, high oil prices.

If the Saudis really are bent on this course, there are no short-term physical or economic factors which would stop them driving oil prices below $20 per barrel. Consumers have adjusted to high oil prices and demand is largely inelastic until - somewhere below a price of $20 per barrel - power stations and heavy industrial consumers consider switching their dual-fired boilers to fuel oil. With the possible exception of some marginal US production (perhaps defended by a US oil import levy), most non-OPEC fields will continue to produce at maximum rate because the marginal operating costs are well below $10 per barrel.

If high-cost UK production really is the primary target of Saudi Arabia and some of its OPEC supporters, should we be contemplating any form of response? Emphatically no. Saudi Arabia is the one producer which has the short-term potential to increase production sufficiently to offset falling oil prices. For the rest of OPEC, the trade-offs between price and volume in an inelastic market make it compellingly obvious that their collective self-interest lies in foregoing marginal production to defend high prices. This may still be unthinkable - from the point of view of face and honour - without support from the non-OPEC producers. It won't be in a month or two, when oil prices are tumbling. Before then, any concession by the UK Government would be irreversible - and

thereafter regretted. (This week's sharp falls in the spot price of oil are probably a short-term psychological reaction to the OPEC meeting. The physical basis for a prolonged slide is still a month or two away.)

Conclusion

Peter Walker should do nothing. That is likely to mean a bumpy ride for Nigel Lawson. It is none too soon to consider the implications.

JM

JOHN WYBREW