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PRIME MINISTER

Prime Minister 2

DRW 12/12

OIL PRICES

At the end of November, the price of North Sea crude stood at slightly over $30 a barrel. By this morning the price had fallen to below $22. It climbed back to $25½ at 4.00 pm this afternoon, but the market is still very volatile and it would be rash to assume prices have stabilised. I believe I should spell out the background to this slide in oil prices and warn you that we will face growing pressure to cut UK production from OPEC and from Saudi Arabia in particular.

Until this summer, OPEC had made no serious attempt to break free from its position as residual supplier. In particular, Saudi Arabia reluctantly acquiesced in its effective rôle as swing producer. Despite having the capacity to produce some 10 million barrels/day, Saudi production fell from that level in 1979 to just over 2 mb/d this summer. Over the same period, OPEC production fell from 31½ mb/d to some 14 mb/d. In this way, declining world demand and a rise in non-OPEC production from 20 mb/d in 1979 to 25 mb/d in 1985 were largely accommodated without a serious collapse in oil prices, although prices did fall steadily from a peak of around $40 in 1981 to a low of $25 in June of this year.

Over the last 6 months, it has become increasingly clear that Saudi Arabia will no longer accept its position as swing producer. As such, it has had to cut production at times of falling prices and in a steadily falling market it is no longer willing to accept the consequent decline in oil revenues. This change of attitude may well have been sparked by the events of this summer, when Saudi production and oil prices both reached a low point simultaneously. Even in the spring, they were heading for a trade deficit of some $20 bn.

From late September, Saudi Arabia began to conclude a number of "netback" deals. Under these deals, Saudi oil is sold at a price related to the price the refiner obtains for oil products. The customer is therefore guaranteed a margin on such oil. In this way Saudi Arabia not only secured an outlet for increased production but also gave up its attempt to support prices. Sheikh Yamani has confirmed publicly that Saudi Arabia can no longer support prices, and has threatened that Saudi production will be allowed to rise to maintain revenues as prices fall. It is now producing close to its quota of 4.39 mb/d.

This, together with similar deals by other major OPEC producers, means that OPEC production as a whole is now some 18 million barrels/day. Attached is a table giving the latest projection of the balance of supply and demand produced by my Department. It shows that if OPEC continues to produce at the current 18 mb/d there is likely to be a surplus in the market of some 2 mb/d in Q1 of 1986 rising to 3 mb/d in Q2 and Q3. This compares with current UK production of some 2.7 mb/d. It is the perception that OPEC will take no action to restrain production that has driven prices down so fast.

The OPEC conference this weekend has been portrayed as having agreed a strategy of defending market share regardless of the effect on price. However, I do not think it is as simple as this. There are still deep divisions within OPEC. Libya, Algeria and Iran, for instance, still believe in the aim of stabilising prices at current levels or higher. Most OPEC members will be worse off because of the fall in prices. Saudi Arabia might benefit if it can obtain a larger market share or if demand increases but the latter is a long term prospect. However, one can say that all OPEC members are agreed that non-OPEC producers should share the burden, and that many members found the presentation of a confrontation with non-OPEC producers an attractive means of disguising their differences. Some may believe that a fall in prices to below $20 will shock us into action, and that probably lies behind the threats of a price war made publicly by the Saudis, Kuwait and Nigeria.

We can therefore expect renewed pressure from OPEC, public and private, to cut our production. I have had reports that Yamani is speaking of maintaining a "fair share" of the market irrespective of price, and that he considers that a "fair share" can only be defined in negotiations with non-OPEC producers.

I believe we should continue to resist this pressure. Apart from the general principle of not interfering in the market:

(a) OPEC show no evidence at present of sufficient unanimity to make any "deal" with them workable, even if that were desirable; and unilateral gestures on our part would be expensive and would achieve nothing if OPEC did not respond quickly and constructively, which I consider most unlikely;

(b) the breach of trust with our licensees could damage the prospects of investment in the UKCS, even though some oil companies may see commercial advantage in higher prices brought about by Government action;

(c) my Department is predicting that the decline in oil demand is unlikely to reverse significantly before 1990: we would therefore run the risk of locking ourselves into lower production for some years and of sharing with Saudi Arabia the burdens of residual supplier; and

(d) in taking specific action to support prices, we could well damage relations with our EC and OECD partners, including the USA, who in general are likely to favour lower oil prcies. As the largest oil consumer, the USA could arguably do more to influence prices than us, if it felt its interests were being threatened.

I am copying this to the Foreign and Commonwealth Secretary and to the Chancellor of the Exchequer.

Secretary of State for Energy

12 December 1985

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10 DOWNING STREET

From the Private Secretary

16 December 1985

OIL PRICES

The Prime Minister was grateful for your Secretary of State's minute of 12 December.

I am copying this letter to Len Appleyard (Foreign and Commonwealth Office) and Rachel Lomax (H M Treasury).

DAVID NORGROVE

Geoff Dart, Esq.,
Department of Energy