CONFIDENTIAL

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NBPM yet.

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1

6 October 1981

Dear Geoffrey

NORTH SEA OIL PRICING POLICY

In your minute of 6 February to the Prime Minister you suggested that officials should review our North Sea pricing policy in order to check that we were not missing any legitimate and sensible opportunities for securing the maximum revenue from UKCS crude oil sales. David Howell, in his letter of 16 February, agreed to this proposal and as a result a working group of officials, under a Department of Energy chairman, was set up. The first phase of the group's work dealt with the circumstances of a tight market. Following the reduction of North Sea prices in June efforts were extended to cover slack market conditions, as you requested in your letter of 5 June.

I enclose a copy of the group's report which has been agreed by our officials. I endorse the general conclusion that as regards the balance between fiscal and diplomatic benefits existing arrangements have served reasonably well. I believe that in the recent softening market our general approach of lowering price in order to retain the volume of sales has proved clearly preferable, in terms of maximising current Exchequer revenues, to that of the African producers. They have attempted to hold up prices for as long as possible and as a result have experienced a precipitous decline in sales and revenues.

When tight markets reappear it would be right to allow UKCS prices to return quickly to close to the top end of the range of world prices though, as always, it would be important to avoid being seen to be overtly aggressive thus attracting diplomatic opprobium.

If you are content with the conclusions and recommendations set out in the report (paragraphs 6.1 to 6.3) I propose to convey these formally to the Chairman of BNOC.

I am sending copies of this letter and the report to the Prime Minister, the Foreign Secretary, Sir Robert Armstrong and Mr Ibbs.

Yours ever
Nigel

NIGEL LAWSON

-6 OCT 1981

NSOPP(81)13

NORTH SEA OIL PRICING POLICY

A Report by Officials

INTRODUCTION

1.1 In his minute of 6 February to the Prime Minister, the Chancellor of the Exchequer proposed that officials should take a fresh look at North Sea oil pricing policy to ensure that legitimate and sensible opportunities for securing the maximum value for UKCS crude oil were not being missed. Accordingly, a Working Party of officials drawn from the Department of Energy, Treasury, Foreign and Commonwealth Office, Inland Revenue and the Central Policy Review Staff was set up under a Department of Energy chairman to examine the issues and report to Ministers. The British National Oil Corporation (BNOC) were also represented at a number of the meetings of the Working Party.

1.2 In June, when market pressures forced BNOC to reduce prices, the Chancellor registered concern at the apparent asymmetry whereby the UK tended to follow others in a rising market while being among the first to move down when prices were falling. The Working Party have accordingly examined UKCS crude pricing in both rising and falling markets.

1.3 Revenues from the North Sea were about £3.8 billion in 1980/81 and on current assumptions are forecast to rise to some £6 billion (at constant prices) by 1983/84. Even relatively small changes in the price of oil have an important absolute effect on Government revenues. For instance, an additional $1 per barrel on UKCS crude (about 3 per cent) in 1981 would have increased the Government take by £240m, of which £180m would have fallen in the current fiscal year. (A 3 per cent fall in the value of the pound has the same effect).

1.4 In preparing this report the Working Party examined how UKCS prices responded to the market, the price relationship between different crude oils, the international implications of the level of North Sea prices, possible avenues for maximising prices in strong markets and ways of minimising reductions in weak markets.

SETTING UKCS CRUDE PRICES: THE CENTRAL ROLE OF BNOC

2.1 When the first UKCS oil fields came on stream in 1975 world oil supplies were plentiful and spot market disposals commonly took place at below term contract prices. UKCS prices were set by the oil companies in negotiation with each other, and the Government's main concern was to ensure that producers disposed of their crude oil at prices which reflected the full term contract value in order to maximise the tax yield. Petroleum Revenue Tax was accordingly levied either on the actual selling price in respect of third party sales, or, in the case of crude oil retained within companies, on a value which was assessed retrospectively in the light of prevailing world market prices.

2.2 The decision taken was thus in effect to reject a "Government Selling Price" approach. UKCS prices were left to follow the market and the main policy emphasis was placed on securing a proper tax take. The market price approach was also a basic feature of the subsequent arrangements whereby BNOC acquires oil under the participation agreements. The Petroleum and Submarine Pipelines Act 1975 established BNOC as the principal agent of majority state participation but the oil was left in the ownership of the producing companies, subject to the contractual terms of negotiated participation agreements. No power was taken to control the prices at which the companies dispose of their equity oil.

2.3 Prior to 1978 BNOC handled no oil. Since then UKCS oil production has rapidly built up; BNOC has exercised its options under the participation agreements to take up to 51 per cent of producing companies' oil after royalty; and the Government has exercised its discretionary right to take royalty in kind for which BNOC has acted as selling agent. In consequence more than half of the UK's oil production of about 1.8 million barrels per day now passes through BNOC's trading account. This gives the Corporation a central role in determining UKCS prices and indeed arm's length term sales by other producers are normally concluded at BNOC prices. As long as the BNOC price can be seen to follow the market and provided there is no evidence of a significant proportion of UKCS oil being sold at other prices, the Oil Taxation Office will normally agree valuations of the 35 per cent of crude transferred between affiliated companies broadly in line with BNOC's negotiated prices. Thus BNOC's prices have effectively become de facto market prices for UKCS crudes.

2.4 The predominant trading position of BNOC inevitably leads to an assumption by some companies and foreign Governments that BNOC, acting on Government instructions, effectively sets quasi-official UKCS crude oil prices. There are however practical reasons why this could not be so under existing arrangements. The terms of the participation agreements give producing companies a contractual right to market prices for the oil acquired by BNOC. These prices have to be agreed prior to the beginning of each quarter. If agreement on prices cannot be reached with BNOC, there is provision for expert determination which is binding on both sides. To avoid a financial loss BNOC must agree in turn with its customers selling prices which reflect the costs of acquisition. BNOC is therefore constrained in its price negotiations on the one hand by producers who will normally seek the full market price to which they have a contractual entitlement, and on the other by consumers who are not normally prepared to pay more than the commercial

value of the crude. BNOC's room for manoeuvre on prices is thus extremely limited. Moreover, in this process of buying and selling BNOC has to deal with some 40 different companies, and to bring the price negotiations to a timely conclusion the Corporation must be able to take quick decisions based on its own commercial judgement.

2.5 BNOC is thus in practice a price taker rather than a price setter. This was clearly shown in June of this year (see paragraphs 3.2ff). Nevertheless the Corporation consults with Government before making price changes. This provides Government with the opportunity to give such guidance as seems desirable and practicable. Current arrangements are set out in Annex A.

THE DEVELOPMENT OF UKCS CRUDE OIL PRICES

3.1 From the beginning of BNOC's trading activities until June 1981 UKCS prices were closely related to those of the more aggressive OPEC producers. This arose largely because the quality of UKCS crude is very similar to the quality of oil sold by those producers (the Africans) and in a firm market where all output is being sold similar crudes should sell for similar prices. It can be argued that BNOC prices, whilst being close to the top end of the range, were nonetheless a little below what might have been achieved, particularly over the past year. To the extent that this occured it was not through any inherent weakness of BNOC as a trader but reflected a perceived diplomatic need for UKCS prices not to outstrip those of all the OPEC producers. A detailed analysis of UKCS prices prior to June 1981 is given in Annex B.

3.2 During the summer of 1980 the oil market moved towards a glut; stocks were high and supply exceeded demand. The product market was characterised by prices which covered the cost of Saudi crude but not the cost of African and North Sea crudes which were some $2 to $3/b more expensive (after allowing for differences in quality). By September 1980 pressure was mounting for a price reduction but the advent of the Gulf war removed the glut and deferred market pressure which did not build up again until the spring of 1981. By then the Saudi price, which again determined the price of products in the market, was more than $4/b below all other prices and refiners could not afford to continue taking other crudes. From quite early in the year the Africans, especially the Nigerians, found they could not sell all their output. By June the Africans had collectively lost nearly 50 per cent of their sales. Meanwhile pressure was mounting on BNOC. The option to reduce at short notice the volume of oil taken was not available to the Corporation because of its term contractual commitments to lift the oil (see paragraph 5.6). Because BNOC's customers had a contractual right to phase out from or suspend contracts if prices could not be agreed, BNOC had little option but to reduce prices to a level at which the oil could be sold. This level is roughly equivalent to the Saudi price and thus, for the moment at least, the link with African prices is broken.

3.3 The recent price reduction has allowed BNOC to continue to dispose of all their available crude, albeit with a loss of some 11 per cent in total revenues, whereas African revenues have dropped by up to 60 per cent because of the lost volume. Thus at least as regards current revenue the UK policy of responding to market forces by price reduction rather than volume has been vindicated.

3.4 Following the failure of the Geneva OPEC meeting to agree on a new unified price structure and production cut-backs, we may expect a continuation of the present weak market for some time to come. For 1982, the Saudis have said they want a price freeze and they have the production capacity to back up that policy. But in the medium term we can expect OPEC to seek a steady increase in prices, in line with their Long Term Strategy.

ECONOMIC AND FISCAL CONSIDERATIONS

4.1 Higher world oil price levels have a number of adverse consequences for the OECD economies generally, including lower growth of real disposable incomes, terms of trade loss, and diversion of investment to alternative sources of energy. Erratic upward oil price movements particularly damage world trade and output, add to inflation and prolong the problems of OPEC financial surpluses. Although the UK would be better placed than other OECD countries (we would not experience a terms of trade loss) higher world oil prices would tend to lessen our competitiveness via the exchange rate effect and would reduce demand for UK exports as a result of depressed world trade. Thus any general increase in the world price of oil would not be in our best interests and it would be undesirable on economic grounds alone for there to be any change to UKCS prices which might trigger an increase in world prices by encouraging the OPEC hawks.

4.2 On the other hand, an increase in UKCS prices which had no effect on world oil prices would tend to be beneficial as a result of higher tax revenues (exchange rate and consequential effects seem likely to be negligible overall). For instance an extra 25 cents a barrel would yield some £45m to the Exchequer in the first year and as much as £100m by the fourth year if the increase were to be sustained.

4.3 In general then, it is in the UK's interest to achieve the highest prices for UKCS crude oil for a given set of world oil prices. But it would not be in our interest if any action by the UK triggered a general increase in world prices. Conversely, it might in principle seem desirable to act in respect of North Sea prices in any way which would help reduce world prices. In practice, however, the relatively small volume of UKCS crude, together with the constraints on BNOC (see section 2), tend largely to preclude such an approach. Thus the range of possible actions is effectively restricted to those that might modestly improve North Sea prices relative to other world crude prices.

SCOPE FOR INCREASING UKCS PRICES RELATIVE TO OTHER PRICES

Tight Markets

5.1 There is no commercial reason why BNOC should not seek top term prices in tight market conditions. The Government have however accepted that to seek the very top prices, as opposed to a price marginally lower, is to risk the leap frogging process in which the more aggressive African producers would seek to outstrip UK prices; this could trigger off a world price spiral which would not be in the national interest. These are arguments which France, Germany and the US urge upon us and are similar to those we ourselves have deployed when we have pressed OPEC countries to be moderate over prices.

5.2 Thus in 1979 and early 1980 the Government took the view that it would be internationally unacceptable for UKCS prices to lead the market which was rapidly moving upwards. BNOC were therefore urged to raise their prices only after all three African producers had first done so. On two

occasions the Africans failed to move in unison and the North Sea producers pressed BNOC hard for increased prices, which the Government regarded as untimely. The Government therefore asked the companies to hold back. In particular, the producers were pressed to forgo a $4/barrel increase throughout January 1980 in the national interest. The producers complained that this was an expensive gesture; by the end of the month the strain was showing and it is doubtful whether the line could have been held much longer. But by then Nigeria had moved into line with the other two African producers and the Government felt able to allow BNOC to raise its prices in line with world levels. Because BNOC had sold its oil at the lower price level failure to have held down the buying price in January 1980 would have cost them some $12 million. The revenue lost to the Exchequer through holding down prices amounted to some £80 m.

5.3 There is perhaps some scope for the Government to stand back a little more than hitherto, thereby allowing BNOC to move ahead rather earlier and to reach slightly higher price levels (perhaps 25 cents/barrel). Indeed, this enhanced freedom to respond to the market was implicit in the decision to stand back as BNOC moved prices down in June this year. Generally, BNOC might be encouraged to achieve the highest prices that the market will bear, while accepting the principle that we should not be seen to lead the market and thereby precipitate further increases in world prices, and subject to the agreed consultation procedure with the Government (Annex A). The balance between these two conflicting elements at any particular time is necessarily a matter for fine judgement. Certainly, an overtly aggressive pricing policy would attract strong international criticism, particularly from the US and those EC countries which have ports on the North Sea, since these are the principle overseas recipients of UKCS oil. We must also expect that an aggressive policy would be used by many OPEC producers to justify their own stance; they would point to the inconsistency between that policy

and past lobbying prior to OPEC meetings when the UK has pressed for price moderation.

5.4 Apart from the question of the general stance on pricing a number of particular approaches aimed at obtaining rather higher prices for UKCS oil in tight markets have also been considered, including the use of premia on top of term prices, spot sales, forward sales, c.i.f. sales and processing deals. These are discussed in Annex C. Our conclusion is that while certain of these are practicable the benefit to be gained would be relatively small.

Weak Markets

5.5 In June 1981 BNOC were forced to cut their prices by $4.25 in response to strong pressure from their customers, against a background of an overall surplus of supply over demand. BNOC had to move before other producers largely because they were not able to reduce their acquisitions of oil quickly. The African producers, in contrast, chose to maintain prices while shutting in production as their customers walked away from expiring contracts. As previously noted, the immediate loss of revenue has been much greater with this strategy. Very recently, however, the Nigerians have decided to cut their prices by $4 a barrel in order to try to recover sales, and there are suggestions that the North African producers are resorting to surreptitious discounting of one kind or another.

5.6 There are two major differences between the position in the North Sea and in the African countries producing comparable crudes, to whose prices UKCS prices have traditionally been linked. First, the African governments are able to cut production quickly to reflect a fall in demand at the prevailing Official Selling Price. In contrast, BNOC has virtually no powers to cut back its short-term availability (see paragraph 5.8), nor does the Government, except through the cumbersome production

cuts machinery in the context of implementing a depletion policy. Second, the Government attaches high priority to the maximisation of Exchequer revenues and little if any importance to keeping up UKCS prices, per se. The reverse appears to be true in the case of the African governments, despite, for instance, the pressing need of the Nigerians for revenues.

5.7 In principle it would be possible for the Government to take steps, most probably involving new statutory powers, to enable crude production to be varied at short notice to reflect market circumstances, thereby helping UKCS prices to be maintained. But this would involve a major change of approach towards the production and disposal of UKCS crude as well as a short-term loss of revenue. There would seem to be little merit in such a departure and it is not considered further. We have considered, however, whether under different conditions the reduction in UKCS prices last June might have been decreased or delayed, given the broad pattern of existing arrangements.

5.8 One possibility was that had BNOC been able to allow customers taking some 200,000 b/d (20 per cent of BNOC's total availability, 40 per cent of freely traded crude) to walk away from their third quarter contracts a smaller reduction in UKCS prices would have been attainable. However, the scope for short term reductions in availability of oil to BNOC are very limited. BNOC's equity oil availability depends on agreement with its partners in the various fields; participation volumes can only be varied with periods of notice of six months or more; and similarly for royalty oil which BNOC sell as agent for the Government. The producers would be unlikely to agree to shortening substantially these periods of notice. Temporary storage of oil by BNOC would in principle be possible, as a means for dealing with reluctant customers, but there would be very real risks that such a move would fail to hold the price and the loss of revenue in selling later at a lower price would be compounded by the cost of

storage. Storage is not therefore recommended as an instrument for influencing price though there may be logistic or commercial reasons for BNOC to store cargoes for short periods.

5.9 Although, as noted, short term reductions in the availability of oil to BNOC are not feasible, it would be possible to reduce longer term availability by declining to take participation oil or by reducing (or eliminating) the amount of royalty collected in kind. From the point of view of pricing we believe that course to be unwise (though there could be other reasons for so doing which lie outside the scope of this report). Major reductions in BNOC's availability would leave the price of UKCS oil exposed to unconstrained market forces. It seems very likely that in the absence of BNOC's steadying influence prices would have moved downwards earlier and perhaps to a greater extent in the Spring and Summer of 1981, given the pressures from loss-making refiners and the depressed spot market for N Sea crudes. The closest parallel is the US market where price reductions started in the Spring and were continuing in a downward spiral of several cuts for each crude, as late as July. Conversely, when markets tighten BNOC's position as the major trader enables the Government to have some influence on events if it so chooses. The absence of BNOC would tend to result in more volatile movements in UKCS prices in both directions.

5.10 A second apparent weakness in BNOC's position during the price negotiations in June was the relative ease with which their customers would have been able to leave crude oil with the Corporation had not agreement been reached on price. Overall, the UK's position is comparatively protected compared with many OPEC countries because of the producers' equity stakes and the various agreements for "saleback" of participation or royalty oil to the producers; the producers would generally be reluctant, or find it difficult in practice, to reduce these volumes (though BP, as sole licensee of Forties, has been able to cut production

temporarily). The problem lies at the margin with the 30 per cent of UKCS output that is sold at arms length by BNOC. The contracts, which are of course subject to normal commercial negotiation, must be appropriate in both slack and tight markets. It seems likely in general that contractual improvements made with a view to future weak markets would tend to lose BNOC revenue in tight markets. Nevertheless, there may be particular contractual terms capable of improvement. For instance, BNOC's forward oil sale contracts allow customers to suspend lifting for a full quarter at minimal notice in the event of disagreement on price, rather than the usual gradual phase out of purchases (this concession was allowed in return for unusually favourable payment terms). BNOC intend to avoid such terms in the future.

5.11 A third possible approach designed to improve prices in a slack market would be intervention by the Government. Pressure by Government last June might have had some effect on those UK-based refiners with long term saleback arrangements though little could have been expected in the case of BNOC's overseas customers at a time when each barrel of North Sea crude refined represented a loss to them of up to $6. In general Government pressure is unlikely to be useful other than at the margin. Companies have recently demonstrated vis-à-vis OPEC producers that there is a point when commercial imperatives override government pressure. Although oil companies have an interest in secure supplies they are not interested in security at a price they cannot afford. North Sea producers are unlikely to accept low prices for extended periods nor would refiners accept high prices. Government pressure should not therefore be seen as anything more than a device for securing some modest advantage, particularly for relatively short periods of time and perhaps in the extent of the adjustment.

CONCLUSIONS

6.1 The crucial element in the determination of UKCS crude oil prices is BNOC's negotiation of a price which is acceptable to both its customers and the producers. Because of the participation agreements this price must reflect the world market price. Any attempt by BNOC or the Government to force the price outside a narrow negotiating range would give rise to a real risk that either producers would demand expert determination of the price (with the possibility of a less favourable outcome) or that customers might refuse to take at least part of their contractual volumes. Nevertheless, because of the scale of its trading operation BNOC is able to bring some steadying influence into the market which would not be available if the companies simply traded with one another. In particular, BNOC can, to a limited extent, help underpin prices in a weakening market and provide the Government with the option of limited intervention in the interests of moderation in rising markets.

6.2 In terms of maximising Exchequer revenues and minimising diplomatic repercussions existing arrangements have served reasonably well. Over the period from early 1978 to the end of 1979 UKCS prices achieved on average somewhat more than their full commercial worth, as judged against the African producers' prices. Most recently, although BNOC was forced to cut its prices when the Africans chose not to do so (losing up to 60 per cent of sales volume instead), the general strategy of taking the market on price rather than on volume has proved to be clearly preferable. Although the Government must expect to be subject to international pressure to moderate UKCS price increases in a rising market the fact that it did not intervene when prices were falling could be used to argue for a similar lack of intervention when the market turns around. One might thereby justify taking UKCS crude prices quickly back

to the top of the range as prices firm, in contrast to the situation in the 1979/80 rising market where Government pressure resulted in more moderate increases, both in terms of the speed of response and the level eventually attained.

6.3 We conclude that scope for action to secure higher prices for UKCS crude oil, against a background of a given level of world oil prices, is relatively limited. We recommend that:

(i) the present arrangements whereby BNOC in effect seek to maximise the price obtained for UKCS crude oil by following the world market in negotiating prices should be endorsed;

(ii) consistent with (i) above BNOC should aim to get the best price for UKCS oil in both firm and weak markets unless specifically requested by the Government to moderate their stance, following the agreed consultation procedure;

(iii) the Government should continue to consider the merits of intervention on a case by case basis, recognising in particular that intervention in the interests of price moderation may result in an appreciable revenue loss to the Exchequer;

(iv) the Corporation should be encouraged to keep the form of their selling contracts under continuous review with the aim of minimising price reductions in a falling market while not inhibiting subsequent price increases as the market hardens.

CONSULTATIONS BETWEEN BNOC AND GOVERNMENT IN THE EVENT OF PROPOSED CHANGES IN NORTH SEA PRICES

In September 1980 BNOC agreed to the following procedure but subject to the reservation that if BNOC was likely to be exposed to risk as a result of Government policy, it would be necessary for the Board to consider the position in advance and if necessary to invite the SoS to issue a direction

(i) The Government will define to BNOC its broad pricing policy and BNOC will continue to be responsible for seeking price settlements in line with that policy. At present that policy involves securing full term market price for UKCS crudes but on a basis which demonstrates that UKCS prices are following and not leading the market;

(ii) BNOC will inform the Department of Energy as soon as it perceives any change in market prices and the extent to which this is likely to put pressure on UK prices;

(iii) Department of Energy will inform other interested Departments. Ministers will be consulted if there appear to be special reasons for attempting to restrain normal market forces;

(iv) in the absence of any decision within Government to seek to intervene, consequent on the consideration at (iii) above, BNOC will be free to determine the appropriate prices for the crudes it sells in accordance with the Government's pricing policy and with shifts in the market;

(v) BNOC will inform the Department of Energy as soon as possible, and in any case not less than a full working day, before implementing the precise changes at (iv) above in order to provide an opportunity for the Department and the FCO to make available any appropriate presentational guidance.

THE DEVELOPMENT OF UKCS CRUDE OIL PRICES

1. The value of crude oil. Crude oils have a wide variety of qualities. The two most important are density and sulphur content. The less dense an oil, the greater the fraction of the more valuable light products, such as gasoline, which may be extracted whilst low sulphur content increases the value of the fuel products, particularly that of heavy fuel oil. Light low sulphur crude (ie 'sweet') oils therefore have a higher commercial value than heavier high sulphur crudes. The common light sweet crudes traded internationally are from Nigeria, Libya, Algeria and the North Sea; thus in a clearing market the price of North Sea oil is closely related to the selling price of African crudes and these are in turn higher than the prices for other crudes.

2. However it is not possible to put a precise commercial value on a particular crude oil. The mix of products which may be obtained depends upon the complexity of the refinery process used, the value of the individual products depends upon the particular market into which the products are sold and transportation costs depend upon location of both the source of the oil and the refinery. Taking all these factors into account the value of a particular crude oil to different refiners may vary on a worldwide basis by as much as several dollars per barrel. However, it is the worth of a crude oil to the marginal purchaser which determines its price and hence crude oils are usually traded internationally at a single term contract price for a particular quality and thus it is important for refiners to be able to make some assessment of relative value of oils. This is particularly true where oil companies exchange crudes and a cash adjustment is needed to compensate for quality differences. For practical reasons calculations are usually performed with a particular market in mind and assuming only simply refining.

3. The main market for UKCS crude is North West Europe and in assessing the price which UKCS crude should command the oil industry tends to make comparisons against the natural competitors ie African crudes. Starting with an official African price it is possible to calculate the approximate value which a refiner would place on a UKCS crude if making a choice on commercial criteria only. This value can then be compared with the actual selling price of the UK crude and the difference is a measure of pricing below or above the market level as set by comparable crudes.

4. Performance of UKCS. The graph at figure 1 sets out the difference between the price of UK Forties and its average commercial worth calculated from prices charged by the Africans. Whilst the precise figures may be a matter of some debate both for the reasons set out in paragraph 2 and because even the prices for different African crudes are not equivalent in terms of commercial value, the graph is illustrative of the general trends from the end of 1978 to the second quarter of 1981 by which time the market was no longer clearing all willing production and individual producers were facing a choice of taking the market either on price or volume but not both.

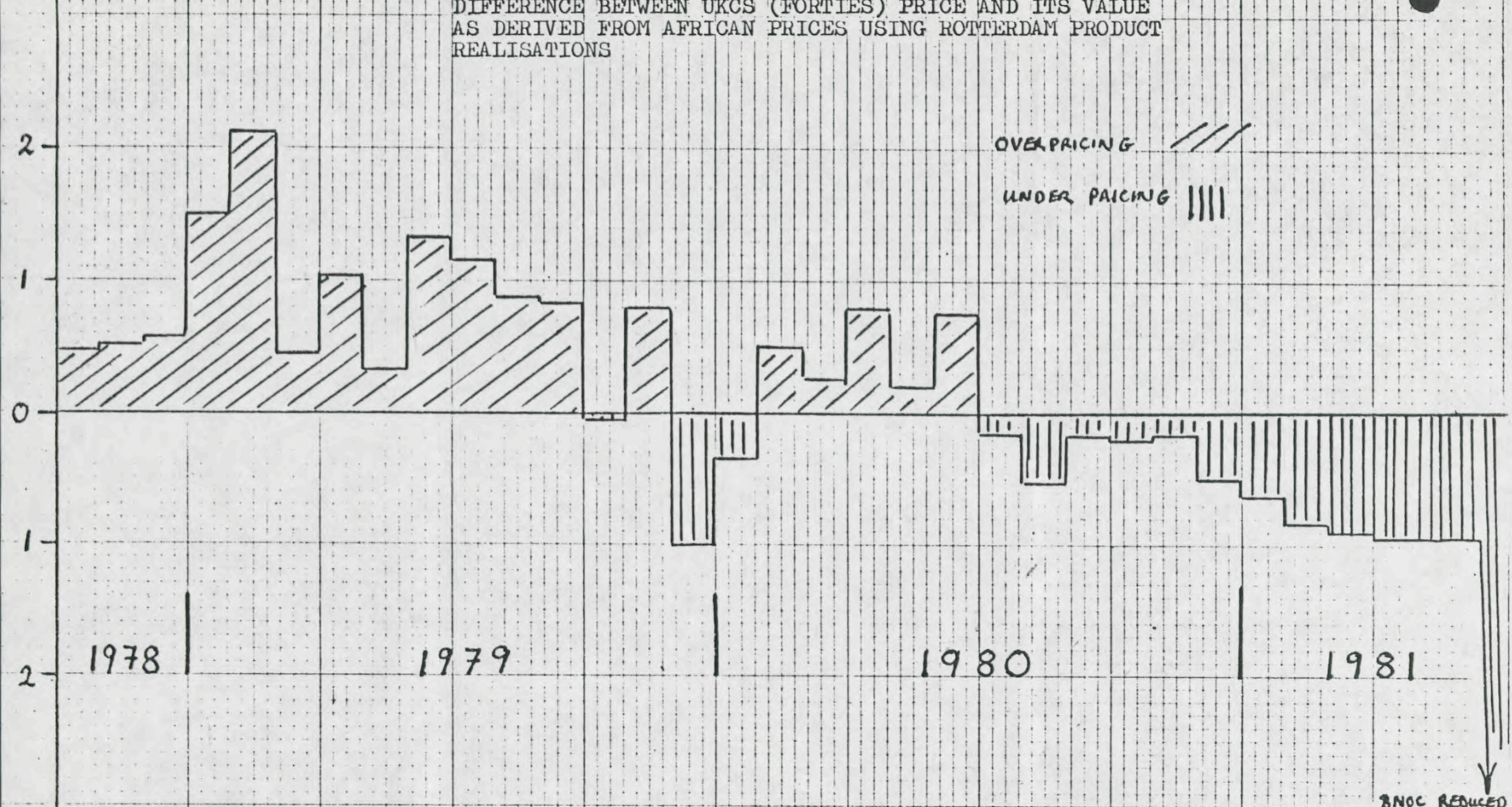
5. For practically the whole period from October 1978 to November 1979, whilst market prices were changing markedly and frequently in the wake of the Iranian revolution the Forties price was above its calculated value, on average by some 90 cents per barrel. This may be one of the

reasons why international criticism of UK prices gathered momentum in the second half of 1979. Relative value calculations are not performed only by oil companies; they are closely watched by the oil press and more importantly by the US Department of Energy.

6. Figure 1 clearly shows the effects of the deliberate policy of price moderation introduced in early 1980. With the backing of strong Government intervention to urge producers not to press their case for an increase, BNOC held back a UK increase after two of the three African producers had increased their prices. When UK prices did move in February 1980 they did so by 21 cents less than the African increases. In May BNOC continued to act with moderation and forewent a further 50 cents increase which could have been justified on the grounds that it would have only matched increases by the Africans. These acts of moderation should have reduced the apparently high pricing levels of 1979 back to the calculated value but during 1980 there were changes both in transportation costs and in theprice structure of the product market. These effects increased the relative commercial worth of UKCS crude compared with African crudes. A third component in the final sum was the imposition of premia largely by Algeria. For the first part of 1980 some two thirds of Algerian customers were surcharged by $5/b. This surcharge was dropped in September 1980. The net result has been that between the end of 1979 and May 1981 the calculated value of UKCS crude relative to African has moved from a clear lead to a position where the value appears to lag by some 90 cents per barrel.

7. But by this time the market had moved into surplus and the higher priced producers became subject to intense pressure for a price reduction. BNOC responded in mid June with a decrease of $4.25/b. The Africans held their prices but were forced to reduce output by over 50%.

FIG. 1



POSSIBLE AVENUES FOR INCREASING THE EFFECTIVE PRICE OF UKCS CRUDE OIL

1. The working group considered how crude oil is sold and examined ways in which exchequer revenues might be enhanced when markets are tight through direct or indirect means. In principle possibilities fall into two classes

(i) direct price increases on term sales either through the actual term price or through premia. These would provide benefits to the exchequer largely through taxation although there would be a modest contribution through equity crude. The scope for increased prices on premia is extremely limited because of the market price provision in the participation agreements. Spot market sales also fall in this class although real benefits can only be secured when markets are very tight and there would be strong pressure from our international partners to reduce spot trading;

(ii) benefits secured by BNOC through special trading arrangements limited to selected customers. The possibilities considered include forward sales, and two minor commercial opportunities which BNOC are already exploring (a price inclusive of transportation costs for delivery to US customers and having part of the crude availability processed so that full value added revenues may be secured). Under BNOC's present financial arrangements the benefits would acrue directly to the exchequer. When BNOC's financing arrangements are brought into line with those of other nationalised industries the benefits would, because of BNOC's high continuing investment programme which makes the Corporation a net borrower for some time to come, in effect secure a reduction in the PSBR.

2. Term prices. Annex B concluded that in some respects North Sea prices have been a little below the commercial value for light sweet crudes, (until the glut in mid 1981). The state of the market is unlikely to permit any unilateral increase by BNOC in the near future although they should be able to match any increase by Saudi Arabia. But even in past tight markets an aggressive pricing policy would have allowed UKCS prices to have advanced by, on average, a modest amount - perhaps some 25 cents/barrel or so.

3. Premia. A premium is a special payment over and above market price, generally in recognition of some benefit such as security of supply. In tight market conditions a number of OPEC countries have been able to collect premia; but events in the first half of 1981, particularly in Kuwait, have shown that when the market softens customers refuse contracts which bear premium particularly if market realisations from the sale of products are insufficient to cover even the official selling price of the crude.

But there is an additional problem in the UK. If BNOC were able to demand premia from some customers, producers would be able to claim that the market price BNOC paid for participation crude should be similarly increased. (There has already been on instance of an expert,

demanded by a company in conflict with BNOC, taking account of the nominal premium associated with forward sales in order to decide on a market price for UKCS crude; it must be expected that other experts would be likely to include any future premia). In effect this would finally lead to the UK price moving up to encompass the premia and the final outcome would be no different to a straight increase in the term price and hence open to the same international objections.

4. Spot sales. For several years prior to 1979 spot prices had not varied marketly from term prices and had in general been marginally lower. The Iranian revolution resulted in spot prices rising rapidly in 1979 at one point exceeding term prices by $14/b. Only in the summer of 1980 did spot prices fall back below term prices. This was short lived, spot prices rising above term prices following the outbreak of the Gulf war. They have since fallen and now stand at some $5/b or more below term prices for African crudes. There are thus great risks in moving into the spot market. Although the benefits are high in tight markets, so too are the losses in slack markets.

5. Forward Sales. BNOC have for the last two years sold limited quantities of oil on the basis of pre-payment. There is no benefit to BNOC but there is a benefit to Government. These payments, received earlier than for normal sales, go to the Exchequer via the National Oil Account; the early payment results in a saving on interest charges since the PSBR is temporarily reduced below the level which would have been necessary without the prepayments. The cost to the companies depends upon the particular arrangements but has varied from 50 cents per barrel to some $2 per barrel depending upon the details of the contract. Where companies finance the pre-payment by borrowing this can be offset against Corporation Tax; but this tax loss would not be entirely lost to the exchequer, in so far as the borrowing is in the UK since there will be additional tax take from the lending banks. At worst half the interest benefit which accrues to Government initially might be lost; but realistically the loss is likely to be considerably smaller. In all, the financial benefit to Government from early payment has probably been in the region of £5 to £10 million for each year of the scheme. Once the financial structure of BNOC is reorganised along the lines of other nationalised industries any interest saving would accrue to BNOC, whilst the tax loss would be borne by the exchequer. Nevertheless the overall benefit should still be seen in the PSBR. In order to put the forward payment scheme in place BNOC had to commit some 150,000 barrels per day of their oil. The current state of the oil market may make it impossible for BNOC to negotiate new forward sales contracts without providing some tangible benefits for the companies.

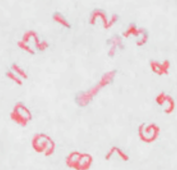
6. Other commercial measures. From time to time opportunities arise for BNOC to increase the revenue from part of their oil sales. Two particular methods are worth noting:

(i) the terms of sale to US customers have been changed from fob (normal sale at production terminal) to cif (sale on a delivered basis). Because BNOC would in total have much larger volumes to move across the

Atlantic than individual customers there should be a saving on transport costs; that might be up to 30 cents per barrel and would accrue to the Corporation;

(ii) processing deals. It might be expected that the sale of refined products should provide greater revenue than the sale of crude oil. At present product prices are depressed and the assumption does not hold, but over an extended period of time it should be true. BNOC is currently looking at the possibility of hiring refinery capacity to turn part of its crude availability into products and hence obtain the full added value. This course would require the consent of the Secretary of State.

-6 OCT 1987



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Prime Minister

MCS 19/10

cc Mr Walters Ingham

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

19 October 1981

The Rt. Hon. Nigel Lawson MP
Secretary of State for Energy

Dear Nigel

NORTH SEA OIL PRICING POLICY

Thank you for your letter of 6 October about the report of the Working Group of officials on North Sea Oil Pricing Policy.

I agree with the report's recommendations (paragraph 6.3) and with your suggestion that these should now be formally conveyed to the Chairman of BNOC. Though I recognise that in current market conditions an increase in UKCS prices is not in prospect, I hope that at the same time you will remind the Chairman of the point, reflected in your letter, and emphasised by Robin Ibbs in his of 8 October, that directly tight markets reappear, it will be important to get North Sea prices up as quickly as is possible consistent with avoiding serious international objection. The importance of prompt action here is underlined by the tax revenue at stake. As paragraph 1.3 of the report points out, even relatively small changes in the price of oil have an important absolute effect on Government revenues: for example, an additional $1 per barrel on UKCS crude increases the Government's take by £240m.

I am sending copies of this letter to the Prime Minister, the Foreign Secretary, Sir Robert Armstrong and Mr Ibbs.

GEOFFREY HOWE

CONFIDENTIAL

Prime Minister

(2)

Foreign and Commonwealth Office

MCS 21/10

London SW1A 2AH

20 October 1981

From The Minister of State

Richard Luce MP

Dear Nigel,

NORTH SEA OIL PRICING POLICY

Thank you for copying to Peter Carrington your letter of 6 October to Geoffrey Howe about the results of the review by officials of our North Sea oil pricing policy.

I agree that the report demonstrates that the existing arrangements have served us well, and in particular that we were right to adjust our price rather than the volume of production in a slack market. I also agree that we shall want to move back to the top end of the range if the market becomes tight and that we could justify this as being consistent with not intervening in a slack market. However, we shall need to judge the precise speed and extent of the price rise in the light of circumstances at the time. As you recognise in your letter, we need to avoid being seen as overtly aggressive, and we could probably wish to avoid being the market leader with our oil at the very top of the price scale, just as we did before.

On this basis I am happy to accept the report by officials enclosed with your letter, and that you should put the conclusions and recommendations to the Chairman of BNOC.

I am sending copies of this to the recipients of yours.

Richard

The Rt Hon Nigel Lawson MP
Secretary of State for Energy
Department of Energy
Thames House South
Millbank
London SW1P 4QJ

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22 OCT 1981

Energy

A Walters
A Duguid

CABINET OFFICE
Central Policy Review Staff
70 Whitehall, London SWIA 2AS Telephone 01-233 7765

From: J. R. Ibbs

Qa 05696

8 October 1981

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Dear Chancellor,

North Sea Oil Pricing Policy

The Secretary of State for Energy has sent me a copy of his letter to you dated 6 October.

I support the conclusions in his letter together with those in the report by officials. In particular I agree with the Secretary of State that when tight markets reappear it will be important to get prices up as quickly as is possible without giving rise to serious international objections.

I am sending a copy of this letter to the Prime Minister, the Foreign Secretary, the Secretary of State for Energy and Sir Robert Armstrong.

Yours sincerely,

J R Ibbs

The Rt Hon Sir Geoffrey Howe QC MP
HM TREASURY
S W 1

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- 8 OCT 1981