INTERNATIONAL OIL SITUATION

Note by the Secretary of State for Energy.

The Western world now faces an increasingly critical oil situation. North Sea oil puts us in a better position to face that situation than many of our partners, but it in no way insulates us from its consequences. I have in recent weeks put to my colleagues papers on a number of aspects of oil policy - the future of the British National Oil Corporation (BNOC) (E(79)67), depletion policy (E(79)58), the possibility of further help to our Community partners (OD(E)(79)39), and the BNOC/BP negotiations (OD(E)(79)43. I shall be bringing forward further papers on such subjects as the implications for us of changes now taking place in the structure of the oil market, and the line to be taken at the Ministerial Meeting of the International Energy Agency (IEA) on 10 December. But we need to consider individual items in the context of the wider scene and our strategy for dealing with it. This paper is intended to set that context.

The Oil Outlook

2. The main features are:-

a) The world oil market should be slacker in 1980 than in 1979. Demand for OPEC oil is estimated to fall by up to 3 million barrels per day (mbpd) as a result of economic recession and measures to reduce demand. A reduction in the output of the OPEC countries is also likely.

They have talked individually about cuts totalling over 3mbpd but in practice I would expect them to be rather less unless the market is very slack. (Annex A)

b) After 1980 and 1981 the market may tighten with economic recovery. At best it seems likely to be in broad balance to 1985 with demand for OPEC oil around 33 mbpd compared with 31 mbpd this year.

c) Decisions on the level of output are made by the rulers of a few desert Arab states who are taking a more conservationist approach than in the past. And there are major risks any of which could disrupt oil supplies:- political upheavals in one or more important producing countries; a renewed Arab/Israel war; worsening relations between the Arab producers and the West; loss of confidence in the dollar and other western currencies. Current events in Iran highlight these risks.

d) Important changes are taking place in the structure of the world oil market. That market has never been a free market. It has previously been controlled by the major international oil companies who have now lost up to a quarter of the oil available to them. In consequence they have drastically reduced sales to third party customers particularly Japan. There has been a big increase in the number of purchasers of OPEC oil and in government to government deals. This increase in the number of companies handling oil has helped push up prices which despite the easier oil market are now more than 65% above their level at the beginning of the year.

e) The world oil market now has a four tier price structure. Companies buying crude oil may be asked to pay

i. the official price,

ii. the official price plus a premium of between \$2 - \$10per bbl. used for term contracts,

iii. Rotterdam spot prices in the range $35 - 40,

iv. the "administered spot price" - typically "key money" to secure term contracts for 1980 (eg. Iran) or prices paid by contractual offtake. Administered spot prices are at or above Rotterdam levels.

The increasing amount of oil that is being sold at administered spot prices is the most dangerous development on oil pricing.

A fuller analysis of the present situation in the oil market is contained in a report by officials on current market developments and their implications which I am circulating under Flag A .

UK Position and Objectives

3. The UK's position as the one major OECD country which for most of the 1980s is expected to be net self-sufficient in oil both presents us with opportunities and exposes us to risks. The opportunities arise from the fact that we should be able to insulate ourselves from the worst effects of the international oil situation if we are prepared to exercise greater control over the disposal of our North Sea oil; that North Sea oil could then be a useful card in political and trade negotiations; and that we could be well placed to act as a bridge between the OECD and OPEC countries. The risks arise from the fact that we may be seen by our OECD partners as siding with the producers and by the OPEC countries as parasitic producers who benefit from higher prices while appearing to criticise them. Our position is further complicated by the facts that we have a major interest in the health of two multinational oil companies - BP and Shell - and that we may get blamed for their decisions and those of BNOC.

4. The oil available at term prices to both BP and Shell is insufficient to meet their world supply commitments. However, BP uniquely among the UK refining companies have UKCS production in excess of their UK refining requirements. It is clearly in the UK's interest that that excess, or part of it, should be retained within the UK at term prices for use by other UK refiners. This will increase the dependence of BP's overseas affiliates on oil from other sources, some

of it at spot prices. But it is to our political advantage, too, that the purchases necessarily made by BP to fill its supply gap are made on behalf of customers in foreign countries. It would then be for those governments to decide whether they wished to object to BP's purchases at the expense of their own supply.

5. In this situation our main objectives should be to:-

a) maintain oil supplies to the UK;

b) work with our partners in the IEA and EEC to stabilise the world oil market and avoid sharp fluctuations which seriously damage the world economy;

c) develop close relations with the OPEC countries;

d) protect the interests of BP and to a lesser extent Shell.

These objectives may often conflict. It will then be necessary to strike a balance between them. As a major trading nation we shall suffer badly from the consequences of a continued international scramble for supplies and rapidly rising prices. But our ability to influence the world market through our access to oil is limited and there is no guarantee that Western Governments will succeed in any conbined effort to bring the situation under control. The maintenance of secure oil supplies for the UK must therefore be our first objective.

<u>Main Lines of Policy</u>

6. Achievement of our main objectives requires the development of coherent policies over a wide area. The main ones are:-

a) an exploration and depletion policy in the North Sea which in the interests of security of supply will replace dwindling production from existing finds and stretch out our limited resources;

b) a disposal policy which has as its first priority the maintenance of as secure supplies as possible to the UK particularly in a sub crisis; and which otherwise as under the present guidelines gives priority to supplies to our IEA and EEC partners.

c) a pricing policy which ensures that we get the benefits of higher prices but which also seeks to silence criticism - indeed, to gain credit, by in general charging the going term rather than spot prices and by making it clear that we are following and not leading the market. (An alternative, but in my view undesirable alternative strategy to this is given below).

d) policies which will ensure that we are not left behind in the competition for government to government purchases from the OPEC countries, while at the same time doing what we can to protect the interests of BP and Shell.

e) co-operate with our IEA and EEC partners to stabilise the oil market and continued co-operation in plans for the international allocation in a full scale emergency.

f) development of much closer relations with those responsible for oil policy in the OPEC countries and other producing countries such as Norway and Mexico.

g) development of closer contacts with the Soviet Union and other Eastern Bloc countries in the energy field. The Soviet Union is the largest oil producer in the world. Changes in her position could have as big an impact on the market as the sort of cut in production from the OPEC countries we are now talking about.

<u>A less virtuous alternative path</u>

7. There is a theoretical alternative strategy which would involve allowing UKCS producers to maximise their return by selling all their production at spot prices and removing all discouragement on them to do so. Were this achievable, it could create an immediate gain of some £2 billion pa to the balance of payments and an increase by perhaps one half in Petroleum Revenue Tax take. To the extent that the course resulted in increased exports of North Sea oil UK refiners might have to buy replacements on the spot market. However, the additional income would not all be in the hands of UK refiners so could not be used directly to offset their costs in buying spot crude. And

though UKCS production is small in world terms, such a policy would infuriate our partners in the EEC and IEA and certainly be cited as a precedent by OPEC producers. I do not recommend such a course, but colleagues ought to be aware that it could be followed if we were prepared for the intended consequences.

The Next Steps

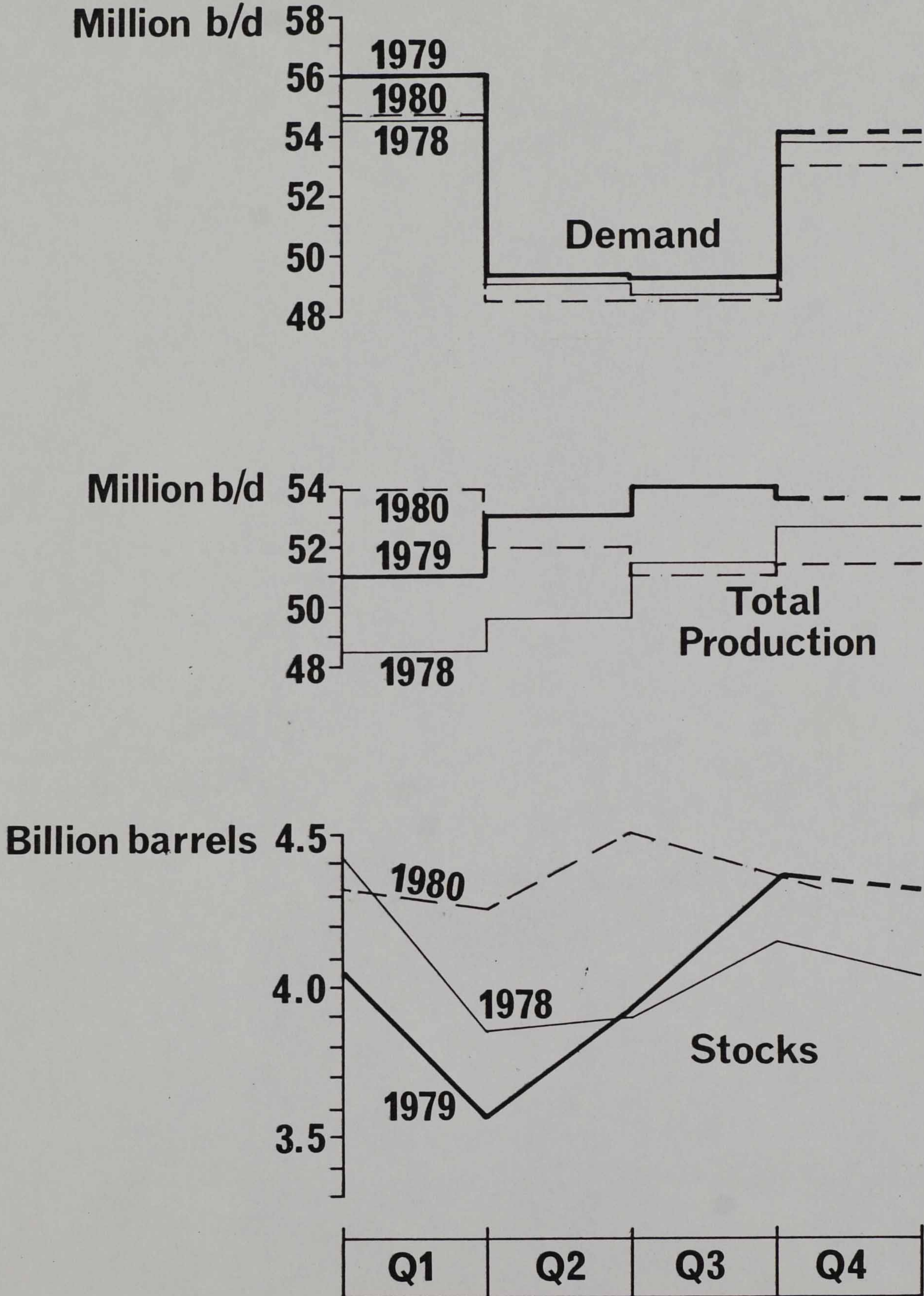
8. Implementation of the policies outlined in para. 6 will require a sustained effort by Ministers and officials through work in international organisations; in explaining our policies to our friends; in developing better relations with the other oil producers including the Soviet Union; and in both economic and political analysis of the oil situation and the intentions of the OPEC countries. We shall need to respond flexibly to a changing situation while keeping our main objectives firmly in view. I shall be bringing forward papers as the need arises on various aspects of oil policy; but I hope we can deal with them all in the general framework I have described.

CONCLUSIONS

9. I ask my colleagues to endorse the general approach to international oil policy set out in this paper.

4 December 1979

ANNEX A



Comparison of Oil Demand, Production and Stocks for 1978 and 1979 with projection, based on a phased decrease in OPEC production from present levels, for 1980