SECRETARY OF STATE FOR ENERGY
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The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
London SW1

message on this transmitted to PM's party in Bristol. PM said content.

3 June 1981

TL 5/6

Dear Chancellor,

In my letter of 22nd May I warned that, if the OPEC meeting in Geneva failed to reach agreement and the market was left in much the state as before the meeting, BNOC would come under very strong pressure to reduce their prices. This has turned out to be so with pressure coming from all BNOC's customers. Esso, BP and Shell have separately made clear to the Department that in their view the price of North Sea crude is now unrealistic and must be reduced.

Philip Shelbourne, the Chairman of BNOC, has today advised me that it is the Corporation's view that, in the absence of any significant cut-back in North Sea production, they will not be able to dispose of all the oil available to them unless their prices for the third quarter (commencing on 1st July) are reduced by $2 a barrel. Without such a reduction, BNOC believe that they could find themselves with 100,000 barrels a day and possibly more on their hands which could only be disposed of at a significant loss on the spot market. Spot prices are currently some $6 per barrel below term prices. Disposing of some 100,000 barrels a day could well cause a further fall in prices and BNOC estimate that if they had to dispose of quantities of the order of 100,000 barrels a day on the spot market, they could incur losses of $1 million a day.

The Inland Revenue have warned that the addition of this extra volume to the spot market would bring with it a risk that companies would seek to have spot prices taken into account when valuations are made for the purposes of PRT. At present the valuation is effectively determined by term prices. This could result in additional and very significant losses which cannot easily be quantified at this stage.

BNOC's policy which we have endorsed has, as you know, been to follow the market, effectively the price set for comparable African crudes. The Africans have not so far reduced their prices but have cut back instead on production; in Nigeria the reduction is believed to be around 30%. BNOC believe that few new buyers will be willing to take these volumes at existing prices and there are reports that Nigeria is offering a $2 a barrel reduction. BNOC believe that their proposed reduction simply reflects the true market situation. They are also satisfied that a reduction now will not prejudice their increasing prices again when this is justified by an upturn in the market.

If a $2 per barrel reduction in the UKCS prices were to last until December of this year, I understand the loss to the Exchequer would be about £150 million for the financial year 1981/2 with a further £50 million in 1982/3 compared with present forecasts. The increase of the sterling price of oil in recent months as the dollar has strengthened is, I believe, likely to more than offset any losses arising from a $2 per barrel price decrease leaving the MTFS planning assumptions no worse off, although there are of course other factors such as production which affect overall revenues. You will nevertheless be concerned at a loss of additional revenue. I have therefore considered very carefully with BNOC whether there is any alternative to the course they propose.

A cut in production of the scale required to avoid a reduction in price is not practicable for the reasons I explained in my letter of 22nd May. Even if it were, we would attract a lot of criticism both here and abroad in cutting production to maintain what is now considered an unrealistically high price. The choice really therefore is between allowing BNOC to lower their prices in the light of the market or of asking them to act against their commercial judgement.

If we ask BNOC to try to hold prices against their judgement, they will almost certainly ask for a formal direction and compensation for the losses they will incur through having to sell substantial quantities on the spot market. Existence of the direction would bound to become public knowledge and we would no longer be able to rely on the argument, which we have so far consistently maintained, that the price of North Sea crude is set by the market and not by the Government.

These objections would also apply if, instead of asking BNOC to defend the price, we took the responsibility for doing so and made public our view that we did not wish to see any reduction in price. Some of BNOC's suppliers and customers might in these circumstances not wish to incur our displeasure by challenging the price. It might then be that much easier for BNOC to dispose of their crude. But there could be no assurance about this. BNOC could still find themselves in the position where they had to dispose of most if not all of the 100,000 barrels a day on the spot market. And in the process we would have incurred considerable criticism from industry and our international partners. We would also have totally undermined BNOC's negotiating power for the future. All the pressure in fixing prices would henceforth come on us and not BNOC. This is something I am sure we must avoid.

I believe therefore that we should stick to our policy of allowing the price to be set by market forces and agree to the $2 a barrel reduction proposed by BNOC. In doing so, we could also win some credit, since once our price has moved down, the prospect of other producers, particularly Nigeria, also being forced to reduce must be increased. But, if we are to do this, we need to act quickly and for the price reduction not to be seen as something which we have conceded grudgingly.

BNOC need an answer preferably by the end of the week and by Monday morning at the latest. They have some 50 negotiations to conduct over the next three weeks and the longer they wait the greater the risk of their losing control over the situation. They would therefore like to start negotiations on Monday. News of the negotiations will inevitably leak. They would therefore propose to brief selected Press correspondents on Monday taking the line that the reduction was following market conditions and prices would move up again when justified by the market.

Your officials have been kept fully informed of BNOC's proposals. I hope therefore that you can, if possible, let me know by mid-day on Friday that you are content for me to inform BNOC that they may go ahead with their proposed reduction of $2 a barrel for the third quarter prices starting on 1st July.

I am sending a copy of this letter to the Prime Minister, the Lord Privy Seal and Sir Robert Armstrong.

Yours sincerely

David Howell

P D A R HOWELL
(approved by the Secretary of State and signed in his absence)

File Energy BK

cc: HMT
LPS
CO

5 June 1981

Your Secretary of State wrote to the Chancellor of the Exchequer on 3 June on the question of BNOC's pricing of oil. I understand that the Chancellor is content with their proposed reduction of $2 a barrel starting on 1 July. As I told you on the telephone, the Prime Minister is also content.

I am sending a copy of this letter to John Wiggins (HM Treasury), Michael Arthur (Lord Privy Seal's Office) and David Wright (Cabinet Office).

T P LANKESTER

Dr. David Lumley
Department of Energy

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