Prime Minister
I'm not sure whether you had a chance to read this paper - relevant to Strasbourg briefing.
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PRIME MINISTER

THE INTERNATIONAL OIL SITUATION

Introduction and Summary

1. You will I understand be receiving tonight a report by officials on the UK's oil and other fuel supply prospects for the next twelve months. However, whatever we decide in the way of changes to increase our own security of supplies, especially through increased supplies of North Sea oil to the UK market, the dangers for us in the overall world oil shortage remains very great. In the first place, even if we used all our North Sea oil (and had the refinery capacity to handle it) we would still have to import a quarter of our oil needs in the current year.

In the second place, we will not be insulated from the deepened recession and trade disruption which a mishandled international response to the oil cutback would bring.

In the third place, while we want to use North Sea oil to cushion ourselves to some extent (more effectively than at present), once we have done that there is an obvious national interest in using our oil to strengthen Britain's international position, and to trade any surplus on world markets to do so.

Thus, although our position is different to that of some other oil-consuming nations, our strong interest in really effective international action remains.

2. Attached are factual annexes on the current world oil supply position, the international action already agreed and the various proposals which have been put forward internationally. Energy is of course likely to be the key area of discussion at the European Council in Strasbourg and the Tokyo Summit. It is essential that we have a well thought through position before then.

3. In summary, my own views are as follows:

(a) Effective implementation of the IEA and EEC decisions to reduce demand by 5% is essential to the solution of both the supply and the price problem. We should continue our own demand restraint measures (which compare well with those taken by others) and press others to be more effective.

(b) We should be ready to join in an international effort to persuade all important oil companies not to buy or sell for the time being on the spot market, whose high prices receive so much attention; and perhaps make veiled threats of possible further action enough to raise doubts in the minds of anyone who deals with it.

(c) In support of (b) we should work for an internationally agreed stockpiling policy designed both to ensure adequate stocks for next winter and to avoid pressure on the market from competitive stockbuilding. We should study further the possibility of governments actually releasing stocks so as to force down spot prices.

(d) On the supply side we should of course continue to do everything possible to increase our own energy production. But we should also do what we can by bilateral visits and discussions to encourage OPEC and other producers such as Mexico to increase production. We should continue to work for more formal international discussions with OPEC if they are willing to have them.

(e) We should be cautious about proposals for import ceilings - this could lead us into domestic allocation. But if this suggestion is strongly pressed by others we might be ready to agree that the existing IEA and EEC demand restraint commitments which apply to the group as a whole should be translated into specific undertakings by each country to hold imports at agreed levels provided that the choice of method for reducing imports is left to individual Governments.

(f) International allocation - doubtfully effective and highly interventionist - would be undesirable at this stage.

These points are discussed in more detail below.

DEMAND RESTRAINT

4. The figuring still suggests (see Annex A) that a fully effective implementation of the existing 5% IEA and EEC demand restraint commitment should be sufficient to bring supply and demand back into balance and ease the current price spiral. The UK is meeting its obligations and must continue to do so. Other countries, admittedly with fewer easy options like fuel switching, have not done so well. We must keep up the pressure on them at every opportunity, particularly at Tokyo. The threat of a world recession which the oil price spiral is bringing ever closer should provide a powerful stimulus to the laggards such as Italy and Germany to fall into line. We might also consider whether there is any way in which we could strengthen the existing IEA monitoring arrangements.

SPOT MARKETS

5. The French have proposed detailed regulation of the Rotterdam spot market in an attempt to reduce spot prices and therefore reduce the upward pressure on OPEC prices. This is unrealistic. If Rotterdam is suppressed other spot markets will spring up elsewhere and nothing will have been achieved. However there is no doubt that very high spot prices are a standing invitation to OPEC to either increase prices or divert supplies from the oil companies to the spot market. In the context of renewed efforts to implement the 5% commitment in full I think it would be helpful if the Summit and IEA countries could agree to persuade important oil companies not to buy or sell on the spot market. The oil companies might agree to a concerted effort of this kind without legal sanctions, although we would have to accept that, as well as lower spot prices the effect would be to reduce crude oil supplies to those countries concerned, at least to some extent.

STOCKPILING POLICY

6. Much of the current presure on oil supplies and prices comes from stockbuilding by oil companies and Governments. Some of this is absolutely essential preparation for next winter. Some of it however reflects general nervousness about future prospects and

the need to meet Government imposed minimum stockholding obligations. My view is that, although the oil supply situation is highly vulnerable, the risk of an oil price induced recession is such that we should be prepared to accept somewhat lower stocks than hitherto in order to keep prices down. Governments might even consider threatening that they might deliberately release oil from strategic stockpiles in order to flood the market. Any action on stocks would need to be undertaken by all countries and would have to be agreed within the IEA and EEC but Tokyo ought to give a strong lead.

DISCUSSIONS WITH OPEC AND OTHER OIL PRODUCERS

7. OPEC countries are of course aware that an oil price induced recession would not be to their benefit either. But we should make use of any bilateral discussions we have with them or with other oil producers who may have some influence, such as Mexico, to ram home the arguments. I will do all I can to develop quickly good contacts with the OPEC oil Ministers. I also agree with the proposition which has already been put to you that, while we may have little direct leverage with the OPEC countries, we should keep open the door in the Tokyo communique to producer/consumer discussions. If OPEC were prepared to have such discussions which is admittedly doubtful, they might find some of our arguments hard to refute. We need to consider very carefully what is the posture if IEA/EEC countries most likely to call for the same response from at least the more responsible Middle East oil producers. And whether we can hope to have any impact on the 26 June OPEC meeting or not. In any case what happens there must have a bearing on what conclusions are reached at the Summit.

The fact of the matter is that without some co-operation with oil producers we cannot solve the problems of price and the balance of supply and demand.

INTERNATIONAL ALLOCATION AND IMPORT CEILINGS

8. Voluntary implementation of the IEA's emergency oil sharing scheme or quantitative restrictions on imports, are concepts which are currently receiving some attention internationally (see Annex B) though it is by no means clear how far our partners will

wish to espouse them. The basic idea is that they would serve to reinforce demand restraint and remove the incentive to purchase at spot market prices, as the buyers might then find their oil allocated away from them at average prices. However the IEA allocation scheme is a complex one, and has never been tried in practice. There is real doubt whether it would really work, particularly if triggered voluntarily in a situation different from that for which it was intended, and with the various modifications which would have to be agreed. There is also a strong possibility that it would lead to oil being allocated away from the UK, and we should lose much of our flexibility to improve our own supply position. The most we should agree to is further study of the possibility of allocation if the situation should get worse, but the IEA scheme itself is not triggered.

9. Import controls might take the form of consumer governments using import licences to restrict their oil supplies to 95% of pre-crisis expectations. Alternatively they might take the form of a statement of intent by each government on oil import levels, which would match the 5% demand restraint commitment. Import licenses would involve considerable EEC complications although they might actually make it easier for us to get a better share of North Sea oil supplies. But this would also involve a new bureaucratic control and a big step towards domestic allocation. The milder variant of a statement of intent by each country on the import levels they would observe might work if backed up by an internationally agreed stance on stockbuilding which would discourage cheating.

SUMMARY

10. To summarise, our vital national interest lies in continuous steps to improve indigenous oil supplies to our market with efforts to strengthen international action. The latter should include concerted pressure to cut demand, moves to help defuse the spot market and

efforts to improve world supply through contacts with OPEC countries, possibly leading to full-scale producer/consumer discussions. It is not in our interest to be drawn, before we have to be, into international allocations scheme.

11. I am copying this minute to the Chancellor of the Exchequer, the Foreign and Commonwealth Secretary, other members of E Committee, and Sir John Hunt.

David Howell

D A R HOWELL
15 June 1979

ANNEX A

WORLD OIL SITUATION AND ITS ECONOMIC CONSEQUENCES

Oil Supply and Demand

1. The latest forecasts for non-communist world oil supply and demand are as follows:

	Million barrels/day (mbd)		
	1978	1979	1980
Non-communist world oil Consumption (ignoring the effects of demand restraint measures)	51.4	52.8	54.2
Non-OPEC oil supply	20.7	21.7	22.8
Demand for OPEC oil	30.7	31.7	31.4
OPEC supply	29.9	29.6	29.8
Stock draw to balance	0.8	1.5	1.6

Source: IEA/GB(79)19

Demand figures modified to exclude the effects of demand restraint measures.

2. The IEA figures assume Iranian production stabilising at about 3.5 mbd from the second quarter of this year onwards, and Saudi production at the Aramco ceiling level of 8.5 mbd. It is possible that Iranian production may be rather higher - though we would not expect it to go above 4 mbd. It is perhaps more likely that Iranian production will fluctuate considerable over the coming months with political developments inside the country.

3. The economic growth rate assumptions lying behind the IEA projections are 3½% for 1979 and 3% for 1980. As will appear from para 8 below, we would regard the assumption for 1980 as too optimistic. OECD oil consumption, and the shortfall in oil supplies in 1980, are therefore unlikely to be as great as the IEA figures suggest. But all this means in effect is that part of the oil deficit will be met by reduced economic growth.

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IEA & EEC Commitments

4. IEA Member Governments are committed to reduce their demand for oil on the world market by 5% (or 2 mbd). No time period for the fulfillment of this objective is laid down, though many IEA governments interpret it as something to be achieved by the end of 1979. The IEA Ministerial meeting in May agreed that extension of demand restraint into 1980 was inevitable. The EEC has an oil savings objective in a rather different form; Member States are committed to holding their collective 1979 oil consumption to 500 million tons, as opposed to the pre-crisis estimate of 525 million tons. There is some doubt however whether, in the absence of demand restraint measures, EEC consumption would have been as high as 525 million tons. The UK should be able to achieve the 5% oil savings target, through the substitution of coal for oil in electricity generation over the summer, a campaign of oil savings in the public sector, additional flaring in the North Sea (which allows increased oil production), and savings by the general public, particularly in response to higher petrol prices and the informal allocation schemes operated by the oil companies. However, the performance to date of IEA governments generally has been patchy. Effective savings by the US will be particularly important, as the US accounts for half of IEA total oil consumption, but our European partners also need to do more.

5. If the effect of demand restraint measures builds up gradually throughout the rest of this year, the 1979 shortfall may be reduced to 0.7 mbd. A 5% saving in oil throughout 1980 should eliminate the deficit next year, and allow a modest amount of stock rebuilding.

Prices

6. In the short term, the demand for oil is relatively unresponsive to price increases. The relatively small absolute shortfall in world oil supplies has therefore been reflected in substantial price movements.

7. The average official price of OPEC crude oil has risen by 32% since the end of last year. All OPEC producers except Saudi Arabia are charging premia on their oil sales, and we can expect that at the OPEC meeting on 26/27 June the Saudis will agree to raise their prices at least to around the average level now being charged by other OPEC producers.

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This would produce a 41% rise in average OPEC prices since the end of last year. Further price rises later in the year are possible, particularly if there are few signs of effective demand restraint by consumers by the beginning of this winter. Prices in the spot market have risen substantially, to over $40/barrel in some cases. The spot market accounts for only a few per cent of total crude oil sales, but it has a psychological effect on the price setting decisions of producers, as a barometer of the potential market value of crude oil. In some cases, producers have deliberately withdrawn oil from contract sales in order to sell it spot.

Economic Consequences

8. A further substantial rise in prices would have significant effects on the world economy. The Treasury's latest World Economic Prospects projection, which incorporated a price assumption (which is now probably too low) of $18 at the end of the year, showed world growth at 3.3% in 1979 and 2.6% in 1980. A large part of this slow-down is accounted for by slower US growth. OECD countries (excluding the UK, Australia and New Zealand) were estimated to move from a combined current account surplus of around $9 billion in 1978 to a current account deficit of $9 billion in 1979 and $11 billion in 1980. OPEC countries were estimated to have surpluses of $20 billion in 1979 and $24 billion in 1980 compared with a small deficit in 1978. In addition, rising oil prices will put severe strain on the payments balances of many oil-importing LDCs, and damage their development prospects by restricting their ability to import capital goods. The scale of the effect of oil price increases on the world economy will depend on the extent to which governments react to higher inflation and worse current account positions. Reactions which reduce growth are more likely the larger oil price increase. As a rough rule of thumb, a 10% increase in oil prices would:

(a) add $16 billion to OPEC revenues

(b) add $13 billion to the OECD oil bill and $3 billion to the non-OECD oil bill

(c) raise inflation by about ½% after a year though this could be somewhat higher if domestic energy prices were raised in time.

(d) reduce growth in the industrial world by about 0.4% after a year (this allows for some policy reaction by governments. With no such reactions and no confidence effects on savings and investments the effect could be 0.2%).

(e) increase the OECD current account deficit by about \$8 billion, of which \$3½ billion would fall to the US.

Effects on the UK Economy

9. The effects of an oil price increase on the UK economy are complicated by the fact that, assuming a floating exchange rate, the pound is likely to appreciate because the UK is thought to be relatively well placed to deal with a world oil shortage. The combined effect of a cut in world growth (para 8(d) above) and the loss of competitiveness due to a stronger pound would be to reduce our GNP. So long as we continue to give priority to keeping inflation under control, the Treasury estimates that each 10% increase in the oil price in 1979 might cut UK GNP by ½%-¾% in 1980, with an associated increase in unemployment. The effect on consumer prices in the UK of higher oil prices would not be large because the appreciation of the pound would offset the effect of the increase in the dollar price of oil.

DEPARTMENT OF ENERGY
15 June 1979

ANNEX B

POSSIBILITIES FOR FURTHER INTERNATIONAL ACTION

1. The existing oil demand restraint objectives of the IEA and EEC are described briefly in para 4 of Annex A. The major possibilities for further action by consumer governments are:

(a) activation of the IEA Emergency Allocation Scheme. It would be necessary to modify the scheme to allow for the fact that the normal 7% shortfall "trigger point" has not been reached. It might be possible to link the right to receive allocations under the scheme with the achievement of demand restraint objectives.

(b) The US have suggested, in the context of preparatory work for the Tokyo Summit, that an informal system of allocation between countries be instituted. If informal allocation did not work, the US would favour "more stringent measures".

(c) Physical limits might be set to oil imports. The US have suggested that each Summit country should set an oil import target for 1979, and a lower target for 1980 (to be reviewed quarterly). The French have suggested oil import targets for EEC Member States for the three years 1980-82.

(d) The present 5% demand restraint commitment could be specifically extended to cover 1980. The IEA Ministerial meeting in May agreed that this was inevitable. It might be possible to reformulate the objectives to make them more watertight eg by breaking them down into individual country objectives for oil consumption (or, alternatively, for oil imports - see (c) above).

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(e) The EEC Commission have proposed that the possibility of a voluntary internal allocation system within EEC Member States be studies urgently, with a view to bringing it into effect before the end of 1979 if the situation does not improve. (This would build on the existing allocation schemes operated by oil companies in a number of Member States).

(f) Concerted pressure could be brought to bear on oil companies not to buy or sell oil or products in the spot market, or not to buy or sell above a given price, or not to buy marginal cargoes of crude or products in the spot market outside their normal trading pattern.

(g) The French have suggested that consumer countries should prohibit the import of crude or products at above OPEC government selling prices.

(h) The French have also suggested various measures to regulate the operation of the spot market, including the establishment of "posted prices". The EEC Commission have proposed that oil companies should be required to notify EEC governments of purchases of crude or products at above OPEC government selling prices.

(i) The existing obligations on oil companies to maintain stocks at or above a given level could be reviewed (in order to discourage oil companies from buying in the spot market solely in order to maintain emergency stocks). The possibility of releasing some emergency stocks onto the market could be studied. The US have suggested an undertaking by Summit countries not to buy for strategic stockpiles when this would place undue pressure on oil prices.

DEPARTMENT OF ENERGY
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