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Prime Minister

This is the study for which you asked after seeing Mr. Roy Jenkins. It is not very encouraging but I fear that it is realistic. Do you agree that it should form the basis of the relevant European Council brief? Bryan 13/6

Yes one.

Foreign and Commonwealth Office

London SW1A 2AH

8 June 1979

Dear Bryan,

The Bargaining Position of OPEC and the West in Future Negotiation on Production and Prices

In your letter of 21 May you asked for advice on how a study could be initiated on the bargaining position of the West, and the EEC in particular, vis-a-vis OPEC in any forthcoming negotiation on oil prices and supply. I sent you an interim reply on 4 June in which I said that officials were preparing a note on the subject.

I now attach a note which has been discussed and agreed with officials at the Department of Energy, Treasury, MAFF and the Departments of Trade and Industry.

I am sending copies of this letter and enclosure to the recipients of my letter of 4 June.

Yours ever

George

(G G H Walden)

Bryan Cartledge Esq
10 Downing Street

NOTE BY FCO, DEPARTMENT OF ENERGY AND TREASURY OFFICIALS

THE BARGAINING POSITIONS OF OPEC AND THE WEST IN ANY FUTURE NEGOTIATIONS ON OIL PRODUCTION AND PRICES

1. The paper in annex seeks to assess the respective bargaining positions of OPEC and the West in any future dialogue on oil production and prices. It concludes that the cards which the West hold are not strong enough to allow them to confront OPEC effectively with demands on price and production levels. In present tight market conditions such an approach would be particularly unrealistic. There is a real risk of OPEC reacting to any approach which they regard as hostile by cutting back production and further increasing prices. That is a risk we cannot afford to take.

2. The paper also concludes, however, that there is a basis and a need for a more constructive discussion with OPEC countries of issues of mutual interest. This would enable the consumers to put across the notion of the interdependence of OPEC and Western economies and to gain acceptance for the need to avoid sudden and sharp increases in the price of oil which are in the interest of neither the West nor OPEC nor other developing countries. We would however have to be careful to avoid such a discussion degenerating, as did the CIEC conference of 1976-7, into yet another North-South confrontation.

3. The paper has also considered the question of a possible trade-off between food and oil. It concludes that EEC food exports to OPEC countries (and western food exports in general) are not a strong bargaining counter. Although EEC food exports to OPEC countries and western food exports generally are substantial, OPEC countries are already getting the majority of their food imports from non-Western countries and could find andpay for supplies from elsewhere if Western supplies were withheld.

THE BARGAINING POSITIONS OF OPEC AND THE WEST IN ANY FUTURE NEGOTIATION ON PRODUCTION AND PRICES

OPEC BARGAINING POSITION

1. OPEC's strength depends largely (though not wholly) on the state of the oil market. From 1977 to the end of 1978 demand was less than OPEC countries were willing to produce. Saudi Arabia was producing well below her self-imposed production ceiling and had excess capacity of nearly 3 mbd. Stocks were high. The nonimal price of oil was steady throughout the period and the real price was falling. The producers' position was therefore relatively weak although the OPEC cartel held together thanks to Saudi willingness to throttle back production. Events in Iran have transformed the market. Last winter Iranian exports (which had been over 5 mbd) were stopped completely. This was only partly offset by increased production in other OPEC countries. As Iranian exports resumed (now 3 mbd) the other producers in several cases reduced production to earlier levels. Demand (including demand for re-building depleted stocks) now exceeds supply by about 1.5-2 mbd. There is no evidence that the OPEC producers with excess capacity (Saudi Arabia, Kuwait, and the Emirates) are willing, as they were last winter, to increase production sufficiently to ease the market. In the aftermath of the Iranian revolution and the Israel/Egypt peace treaty, the Saudis in particular are concerned to adopt a less exposed line in OPEC on production and prices.

2. The implication of this is that unless and until effective demand restraint measures are implemented by the consumers the market will remain tight; and OPEC countries will not find it difficult to increase prices more or less at will. Already OPEC government selling prices have risen by over 30% this year to an average price for Middle East oil of about 17 dollars a barrel, and further increases are likely to be decided at the OPEC

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Ministerial meeting on 26 June. Prices in the admittedly marginal (3-5% of the total) spot market have more than doubled to over 35 dollars a barrel over the same period. In present and prospective market conditions therefore, OPEC's bargaining position is strong: indeed, given market pressures, it is difficult for individual OPEC countries to exercise a moderating influence even if they wanted to.

[A] 3. The prospects up to 1985 were examined by an interdepartmental group of officials, whose report the Prime Minister has already seen. Briefly, the report suggests that, in the absence of any surprises between now and 1985, supply and demand might broadly be in balance by the latter date. The uncertainties are very great, however, and we could be in for a bumpy ride; it is more likely than not that political and domestic economic factors in OPEC countries, "accidents" on the supply side, and shortcomings in the industrialised world's plans to restrain demand for oil effectively and to increase the production of nuclear and other alternative forms of power, will all lead to a tighter market and to a further increase in the real price of oil. A good deal will depend on the rate of world economic growth. If this is very low the pressures on oil prices will be less but the implications for unemployment, investment and adjustment will be serious. In any event, the real oil price will increase substantially by the end of the century.

Bargaining strength of the West

4. The West's strongest bargaining card has been its strategic and military support for some of the producers especially in the Gulf. But following the Iranian revolution and the signature of the peace treaty between Egypt and Israel this card is no longer so strong. Other possible bargaining counters for the West are:

(a) The industrialised world supplies much of the technology, skilled labour, manufactured goods and services without which

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OPEC countries could not develop their economies. This is an important factor which could be stressed in any negotiation. It underlines the theme of interdependence. But it is not a real bargaining counter. The consumers need to export to OPEC to offset their growing trade deficits; it would damage them to refuse to do so; and OPEC countries could always turn to the East for technical expertise and technology they could not supply themselves.

(b) The industrialised countries possess the technology needed to exploit producers' oil and gas reserves to the full. It would be self-defeating, however, not to assist in the development of the OPEC countries' energy resources when we clearly need them. Threatening to play this card could moreover merely accelerate the existing tendency among the producers to recruit and pay for the skills and technology they required on the open market. Some countries like Iraq, are already largely self-sufficient and able to reach their desired levels of production without substantial outside help. Other producers might turn to the Soviet Union, which could partially offset a withdrawal of Western technology. The West could, however, offer to work with OPEC to instal the technology they now need to exploit their gas reserves to the full and to reduce gas flaring.

(c) The industrialised countries could offer the improved access to their markets that OPEC seeks. In the short term this seems to be one of the consumers' strongest cards. But greater OPEC access to Western markets would have adverse implications for some sectors of our economies (in particular refining and petrochemicals) and will need to be traded for tangible concessions on oil production and prices. And any attempt to deny access could lead to the producers withholding supplies of crude oil.

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(d) The industrialised countries possess the financial markets through which the producers can invest their surplus oil revenues. But, while it is true that OPEC will want to protect their investments and therefore have a direct interest in the West's economic strength, the higher oil prices they are currently obtaining more than offset the losses on their dollar investments;

(e) The West is OPEC's main supplier of defence equipment and military training. To threaten to withhold defence sales would however be very confrontational and probably counter productive. In any case not all OPEC members depend on the West for arms (eg Libya, Algeria and Iraq). Such a threat would therefore only have limited application and could open some areas to the USSR.

(f) The EEC and the US are together considerable exporters of food stuffs. In 1976, the most recent year for which figures are readily available, OPEC countries imported food from:

$ million

EEC	USA	Eastern bloc	ldc's	Rest of World	Total
1611	1236	467	2072	934	6320

These figures show that OPEC countries have fairly diversified sources of food supply; and they have been diversifying further by channelling large sums in recent years into the development of food supplies in ldc's such as the Sudan. In 1976 the EEC and US together supplied some 45% of OPEC needsIf these exports were stopped, OPEC countries would undoubtedly experience reductions in local availability for some items. They would, however,be able to find and pay for alternative supplies from elsewhere. We conclude that any

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attempt to put pressure on OPEC by threatening to withhold food would fail, and would invite retaliation. Moreover, the EEC would be deprived of valuable outlets for some food stuffs which tend to be produced in surplus.

5. The consumers' bargaining position could improve if conditions in the oil market changed. The root of the present problem is the West's propensity to consume energy. Unless we can reduce consumption we are never going to be in a strong position vis-a-vis OPEC countries. The industrialised countries could and should cut their demand for OPEC oil (along the lines of recently agreed IEA and EEC demand restraint measures) and develop alternative energy sources. But these changes will not in the foreseeable future alter the fundamental balance between the two groups of countries. In present circumstances, the consumers are in a particularly weak position. If they wish to open discussions with OPEC, they will therefore need to adopt a cooperative rather than a confrontational approach. To confront OPEC with demands on oil prices and production levels would get nowhere. And the market is now such that the producers can and are quite likely to respond to any approach which they regarded as hostile by cutting back production. The consequent price increases would more than offset any loss of OPEC revenues from the reduction in the volume of sales.

6. But if the consumers are in no position to confront OPEC, their hand is not so weak as to rule out entering into a carefully managed discussion of issues of mutual interest in a cooperative spirit. The consumers will need to speak to all the major OPEC producers, not just to the Gulf producers and Saudi Arabia, whose ability to influence OPEC in moderate directions has been weakened by the events of the past six months. Whether or not more direct discussion of OPEC production levels, such as the French seem to be suggesting with their idea of a annual review of forecast production and consumption levels, will prove feasible will need

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further study. The themes which could be developed are:

(i) the economies of OPEC and the West are increasingly interdependent. There is a close interrelationship between crude oil prices, production and demand levels on the one hand and economic growth, inflation and the export price of manufactured goods on the other;

(ii) sudden and excessive oil price increases damage Western economies, and both OPEC and the West would suffer from any resulting recession. Inflation does not just damage the West but OPEC as well, by increasing export prices for manufactured goods and by eroding real oil prices and the value of OPEC financial assets;

(iii) large and sharp rises in the real oil price are likely to be followed by a fall in demand and a slack market. This sort of see-saw and the corresponding fluctuations in oil revenues are likely to be against OPEC's economic interests as well as those of the West. It is in the interest of both sides to avoid violent and unpredictable fluctuations in the oil price, though not all OPEC producers (or all Western consumers) yet accept this argument or its implications;

(iv) if the West is damaged economically, it will also be weakened strategically leaving us less able to protect the Saudi and Gulf regimes (para 4(e) above);

(v) if OPEC were seen to be deliberately raising oil prices and as a result causing world depression, OPEC countries could well find themselves politically isolated not only from the West but from the rest of the developing world.

7. The influence of the oil importing developing countries could be an important factor in any negotiation; and it could work either for us or against us. The producers have shown

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themselves to be very sensitive to criticism from the developing world of their price policies, and their failure to take account of other developing countries' interest. The recent UNCTAD conference at Manila has shown this clearly. So far the poorer LDC's have shown little inclination to break with their OPEC allies. It would suit us in some ways if the LDC's were to open their own dialogue with OPEC, but we have to accept that for different reasons neither the LDC's nor the producers will agree to the industrialised consumers extricating themselves from such a dialogue. There are signs that OPEC are trying to consolidate their position with the LDC's by resuscitating the link between oil prices and the range of North/South issues of concern to the LDC's which some OPEC countries tried to establish at the time of the CIEC (1976-7). If we ever got to a position where OPEC collectively linked North/South concessions with the supply of oil this would be very damaging. The West needs to do all it can to avoid this outcome, which could lead both to unacceptable demands for concessions on trade, aid and technology transfer and to a sterile discussion on the subjects of importance to us, by showing practical sympathy for the plight of the oil importing developing countries by helping their own development of their energy resources and by convincing them that they stand to gain as much as the industrialised world from increased international cooperation on energy issues.

8. The question of possible contacts with OPEC is likely to feature prominently both at the European Council in Strasbourg and at the Tokyo Summit. If the Prime Minister broadly agrees with the line set out in this paper, it could form the basis for briefing on the subject for both these meetings. The West needs to research and coordinate its approach. Some work has been done on defining the West's objectives in any contacts, but no conclusions have yet been drawn. The European Council should

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perhaps give impetus to work within the EEC, already under way in preparation for the proposed meeting on 28 June between Yamani and M. Giraud (for the French Presidency). The Summit could give an impetus to work within the IEA (of which France is not, however, a member).