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DEFENCE AND OVERSEA POLICY COMMITTEE

A POSSIBLE APPROACH TO THE OIL PRODUCERS

Note by the Secretaries

The attached paper has been produced by the Official Committee on Relations with Developing Countries (DCO) in response to a request for an official study from the Secretary of State for Energy. The Official Committee suggest that Ministers may find that the report contains relevant background material which would be helpful to them at the Venice Summit, in advance of consideration of the report itself by OD Committee. This material will of course be drawn on in the preparation of Summit briefs.

2. Thereafter the paper will be considered at a convenient meeting of OD. Its conclusions are summarised in paragraphs 30 and 31.

Signed R L WADE-GERY
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Cabinet Office

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A POSSIBLE APPROACH TO THE OIL PRODUCERS

INTRODUCTION

1. In a minute dated 28 January to the Lord Privy Seal, the Secretary of State for Energy suggested that officials should examine the pros and cons of making a positive approach to the oil producing countries, by suggesting to them that if they were to follow responsible policies on oil prices and production, the West might be prepared to respond with economic policies helpful to them, including the transfer of additional resources to the developing world. This report examines this issue further, as a basis for consideration by Ministers.

2. There have been a number of previous attempts to develop a useful dialogue between oil producers and consumers (see Annex A). But on the whole these have made little progress because OPEC countries have relished the power and money which unfettered 'sovereignty' has brought them; OECD countries have felt unable to offer the sort of concessions which the OPEC countries might find attractive; and OPEC has been fearful that a genuine consumer/producer dialogue would range against them the third world countries whose interests have been so damaged by their pricing policies. But oil is undoubtedly the most important single commodity in international trade and oil prices and production levels are of major significance in the world economy. Large sudden increases in oil prices, as in 1973/74 and 1979, have an extremely damaging effect on economic growth, trade balances and inflation in the OECD countries and have bitten deeply into the pockets of the non-oil developing countries. The OECD Secretariat have calculated that, by 1981, the real income loss to OECD could be \$300-\$400 billion. This arises from direct transfers to OPEC, from the direct effect of the resulting reduction in demand within the OECD area in so far as the OPEC countries cannot or do not choose to spend their incremented revenue within the OECD area and from the indirect or multiplier effect of this reduction within OECD. A rise in oil prices as low as \$2 a barrel reduces OECD GNP by 0.3 per cent after one year; and results in a \$17 billion deterioration in the OECD current account position in a full year, and a 0.5 per cent increase in inflation after one year. Although North Sea oil protects us from the direct consequences of oil price increases for the balance of payments, our economy is highly vulnerable to the effect on the world economy.

3. Oil price increases also impose a heavy burden on oil importing developing countries. Their oil bill will go up from £26 billion in 1978 to $51 billion in 1980, or from 16 to 20 per cent of the value of their goods imports. Lower OECD growth will cut their opportunities to earn foreign exchange: every 1% reduction in the growth of the industri countries for a one-year period is estimated typically to cut the export of the non-oil LDCs by about 1½%, or over $2 billion. Their imports of investment goods for development will meanwhile suffer from oil-induced OECD inflation. As a result their current account deficits (excluding official transfers) will more than double from 1978, to $64 billion in 1980 even assuming no further increase in the price of oil. They could need some $40 billion in banking and other commercial credits for this in 1980. As they become less able to run increasing deficits of this or their growth will be cut back. With the OPEC surplus expected to amount to $135 billion in 1980, this will pose major new recycling problems, no only for the non-oil LDCs but for the industrialised countries and the world monetary system, even increasing the incentive for oil producers to adopt conservative depletion policies. Meanwhile the poorer LDCs wh depend chiefly on aid will also lose out; oil price rises will preempt aid receipts, and reduce total aid flows from industrialised countries. They will have to struggle hard just to stay where they now are.

4. Faced with this situation with all its attendant risks and faced also with OPEC's unwillingness to discuss, let alone bargain about, oil supply and price - the OECD countries have concentrated their attention on the development of their indigenous energy resources, energy conserv and on substitution of other fuels for oil. It is arguable that the re effort they have so far made to secure a means of independence from OPE in these ways falls far short of their potential. But even if countrie were willing to make the necessary financial and other inputs it is cle that, given the long lead times on energy investment, the benefits woul accrue only slowly and would be unlikely to make a major impact on the oil market much before the 1990s (though clear evidence of progress ra than plans in this area might affect OPEC attitudes more quickly).

5. In this situation an accommodation with the oil producers for which, if it is achievable at all, the West would have to pay a substantial price, is an obvious way of guarding against the risk of a scarcity of oil and steep increases in its real price in the coming decade. The remainder of this paper discusses what the OECD countries might hope to achieve in such an accommodation; what they might offer in exchange; and how robust any such accommodation might be. It also considers the means by which an approach to the producers might be attempted.

WESTERN OBJECTIVES

6. The essential Western objective is to reduce, as far as possible, the possible energy constraint on economic growth - a constraint which arises both from supply and price. On the supply side we would want assurances of sufficient OPEC production to balance the market. To quantify this objective means making assumptions about how fast the Western economies could grow without an oil constraint and the effectiveness of oil substitution and conservation policies. For instance, OPEC production rather above the present level would probably be needed to sustain a 2.5 per cent OECD growth rate for the early 1980s. If there were higher growth rates later in the decade (say 3.3 per cent/year), we might need OPEC to produce about 35 mbd in 1990 - a figure which could only be achieved by a massive investment effort by the OPEC countries, which they show no sign of wishing to undertake.

7. If we were concerned primarily about supply, we could seek to confine negotiations to the Gulf producers, who have the largest reserves and control most of OPEC's discretionary capacity. Indeed, an agreement with Saudi Arabia alone would be of real value. There are some indications that it might be easier to begin discussions on supplies rather than prices. On the other hand, many of the dangers of political accidents would remain; and the existence of adequate supplies probably would not by itself prevent OPEC countries from pushing prices up by exercising their monopoly power.

8. In their long-term strategy report OPEC have proposed the fixing of an indexed floor price for crude oil (see para 10 below). However Western objectives in this area would centre around the aim of a ceiling price (which the OPEC report did not propose). Achieving a controlled movement in a ceiling price for oil goes directly to the heart of the problem - the danger of sudden, steep price increases. But it would be more complex to negotiate and would have to involve most if not all OPEC countries, not just the Gulf States. It would require supporting arrangements on supply, and on the control of spot prices and prices for non-OPEC oil (since OPEC would not agree to let others profit from their price restraint). Oil prices would tend in practice to be pushed up to the ceiling level.

9. Other, secondary, Western objectives might include an increase in direct recycling of all kinds to LDCs, particularly for energy projects, in order to place part of the burden where it properly belongs (though it should be noted that OPEC's aid record is already better in many respects than that of the Western countries (see para 24 below); assurance on a return to long-term contracts for oil supplies - which have largely disappeared in recent years; and restrictions on OPEC's recourse to spot market sales; and avoidance by OPEC of routeing and transport restrictions.

THE OPEC SHOPPING LIST

10. The most recent summary of possible OPEC objectives for concessions from the West is contained in the report of the OPEC long-term strategy committee. This was published only in summary form. It is to be further considered at the OPEC summit in Baghdad in October. Among the main proposals in the report are the fixing of a floor price for crude oil (which would be adjusted quarterly in line with inflation, exchange rate movements and GDP in OECD countries). In addition they seek free access for their products in Western markets, transfers of technology and research and development and increased location of energy-intensive industries in their countries. Although these are not covered in the

OPEC spokesmen have also for a long time indicated their desire for concessions regarding the value of their financial assets in the industrialised countries, for example through indexation, and some arrangement for co-operation with the industrialised countries in developing the energy resources of the LDCs. They may also be expected to seek concessions on political support, including arms supplies. These areas are considered in turn below.

11. Prices OPEC are by and large able to enforce their price objectives without the need for our agreement or co-operation.

12. Oil related industrial development and entry to markets
The OPEC countries will press the West to make tariff concessions on their exports of refined petroleum products and petrochemicals, and maybe also for the products of energy intensive industries which they hope to develop. These could involve a significant cost for the UK; in the case of Petrochemicals reduced tariffs coupled with cheap feedstocks could make OPEC countries super competitive, at a time when East European supplies may already be adversely affecting the sector which is in any case likely to be suffering from tight margins and over capacity until the late 1980's. These concessions would only be justified if the price, in terms of assurances on oil supplies and/or prices, was right. But in any case there is some doubt, about how much value OPEC would attach to an offer of tariff concessions - since the economic penalties of refining etc, far from markets are probably more important than tariffs. Making concessions to OPEC might increase pressure from other LDCs to make similar concessions on products of interest to them. Apart from tariffs, there are some lesser concessions we could offer, such as participation in joint R and D projects, or studies on the use of associated gas, or concluding framework agreements to promote oil exploration in OPEC countries, but these are unlikely to be worth much by themselves.

Treatment of financial assets

13. Indexation of financial assets (IFA) has been an OPEC demand for several years. It was discussed at the CIEC; at that time Western participants were united in opposing it. The G77's draft agenda for the forthcoming Global Negotiations calls for the 'guaranteeing' of the real value and 'safeguarding' of the 'financial assets of developing countries'. This demand primarily reflects the views of the 'low absorbers', notably the Saudis. Their argument is that oil is their only resource and that if they are to keep up production they should receive assets yielding broadly the same kinds of returns as those they would expect from leaving their oil in the ground. They have not specified the kind of indexation system they want but they seek to avoid the losses suffered in the past as a result of massive placements in depreciating dollars.

14. Part of these concerns could be met by a wider range of investment opportunities in the international financial system. There has been progress on this in recent months, largely through a change in attitude by the Germans and Japanese on external borrowing and the international role of their currencies. There has been a greater take-up of equity (eg Kuwait in Germany); German and Japanese issues of DM and yen bonds to the Saudis; and Japanese, German and Swiss measures giving easier access to their markets for OPEC funds.

15. In addition, positive real rates of interest have recently emerged in other EC countries. The tough anti-inflation policies now pursued in OECD should reduce the risks of loss on financial assets. There are signs that, for the moment, the Saudis are devoting their attention to pricing issues and are content with the assets on offer. But the amou which they and other OPEC countries have to invest are huge and their perception of the adequacy of existing assets and the likely success of Western anti-inflation policies could easily change.

16. The offer of IFA would increase the security and attractiveness of financial assets in comparison with the return on oil left in the grou

It would thus provide an incentive to Saudi Arabia and the other low-absorber OPEC countries both to maintain or increase their production levels and to enter into agreements with Western countries in this field. A direct inducement to high levels in production might be provided by offering indexed assets in return for sales of oil above reference levels based on past export performance. In addition, an IFA scheme could increase the willingness of OPEC countries to lend their surpluses long-term and could reduce the risks of monetary instability caused by switching of OPEC funds between currencies.

17. Against this, it is necessary to weigh the cost of offering IFA. There are two difficulties of principle. First, indexing assets for OPEC would create pressure for wider indexation, eg of the assets of other LDCs. Second, it is argued that IFA might protect OPEC countries from the inflationary effect of oil price increases and to that extent might make pricing decisions less rather than more responsible.

18. The banks could clearly not be persuaded to offer indexed assets unless they were protected by indexation of liabilities. This would spread the demand for widespread indexation. It would therefore be necessary for Governments to cover the 'indexation risk' of banking operations or, more likely, to construct some inter-governmental apparatus to take over these recycling operations. Governments would have to decide the terms of the new indexed asset and the amount offered; how to distribute any eventual financing burden; and how to link the issue of IFAs with durable OPEC commitments commensurate with this major Western innovation. This would pose very serious technical and negotiating difficulties.

19. Any issue of IFA on a large scale would require an agreed approach with other Western countries, especially the United States and our major EC partners. Although the question does not appear to have attracted much recent debate, financial circles (both public and private) in the US and Germany have in the past been strongly opposed to the idea of IFA. The breakdown of the Substitution Account discussions (on the question

of maintenance of value) and the recent decision of Congress against an oil import levy shows the extent of the difficulties which would have to be overcome.

Political support

20. In general, the political interests of the oil producing countries are so disparate that it would be difficult to devise a political inducement that was attractive to all of them. Indeed, there would be cases where an inducement for one country would entail adverse consequences from another; for example, backing Iran would antagonise Iraq. There are, however, some important oil producers (eg Saudi Arabia) which regard their relationship with the West as essential to their security. This consideration affects their oil policies and it is very much in our interest that it should continue to do so.

21. The Arab oil producers have a common interest in seeking a major change of Western policy on Arab/Israel. However, the United Kingdom, even with the support of the European Community cannot by itself produce the changes on the ground which the Arabs seek. Only the United States has sufficient influence over Israel for this. The Arabs would therefore value a change in British or Community policy principally to the extent that it exerted pressure on American policy. But any such change on our part (which would need to be considerable) would be constrained by domestic political factors and by the need to avoid damage to our relations with the United States. Nor could we be sure that American policy would be influenced in the direction intended. For their part, the Arabs could not be relied upon to fulfil their side of any understanding in the face of other political pressures.

22. None of this of course excludes serious efforts to help achieve a solution in the Middle East, for example by promoting a European initiative. We would seek to persuade the Arab oil producers that we are working to meet their concerns. We should also continue to argue generally that the West, and specifically the United States, can in the end produce a

solution to the Arab/Israel dispute and that Western governments and public opinion are more likely to be responsive to Arab concerns if there is demonstrably a cooperative relationship, beneficial to both sides.

23. Arms A number of OPEC countries, eg Libya and Algeria, are dependent on the Communist countries for their defence equipment and military training. Most of the others are well disposed towards the West and use Western military equipment. For the first category and for Iraq, it seems doubtful, for wider political reasons, that the West would wish to add to their armouries. For the second, it would not be in our commercial or political interests to threaten to withhold arms. As is the case with political support, the UK or even the Nine cannot compete in the American league over military support. It could be argued that the Americans have already obtained Saudi oil at lower prices and in increased quantities in exchange for an understanding that they would support the Saudi regime in case of external attack or internal subversion.

24. Aid Several OPEC spokesmen have insisted that an increase in aid from the industrialised countries to the non-oil developing countries would be an essential precondition for any producer/consumer dialogue (the same point was made in the Caracas Ministerial Communique of August 1979). OPEC's own aid has varied between 1.1% and 2.7% of their GNP, while Western countries still average less than half the UN target of 0.7%. Oil price rises do increase the requirements for aid, chiefly for the poorer countries already suffering from low growth; but the main result is a need for more commercial credit, to which the better off LDCs, who consume most, must look to meet their extra bills. At the same time, Western economic gains from a smoother real price trend for oil should in principle reduce constraints on public spending, making it easier to increase aid again faster.

25. OPEC members' motives and ideology are mixed, but they share a common interest in securing their political flank against G.77 colleagues by producing something to their benefit within the "New International Economic Order", and by deflecting the growing pressures upon themselves to raise aid flows very substantially or to introduce two-tier pricing.

They are likely to continue their own aid efforts. The OPEC Special Fund is to be converted into a permanent agency, and its capital brought up to $4 billion; and members have the option of providing some of their aid in programme form (ie to pay for oil); but they will want to limit this burden and share it more equally with the West. For tactical or ideological reasons, they would therefore probably press for an increase in Western aid over time as part of an accommodation. But this is likely to be only a subsidiary aspect of any discussions with the oil producers. They have no direct interest in the issue, and could, like us, argue that any understanding which had the effect of smoothing the path of real oil prices and reducing the risk of price shocks would be of considerable value in itself to the non-oil developing countries.

PROSPECTS FOR SOME FORM OF AGREEMENT

26. However desirable some form of agreement might be it has to be recognised that the chances of bringing the oil producers as a whole to enter into a satisfactory agreement specifying in detail production levels or prices are remote. OPEC countries have up until now insisted that these subjects lie entirely within their sovereignty. At the moment there is not even a dialogue on energy. The first step therefore is to get one started, and to work initially for an informal or general understanding which might be built on later.

27. In theory such an agreement or understanding might more easily be reached with some rather than all OPEC members, since their political and economic interests are far from honogeneous, they are suspicious of each other. On the other hand they have said in terms that they would only enter into a dialogue as a bloc. Some kind of general statement of intent in which the OPEC and OECD countries recognised their mutual interests would not be without value, even if a more specific agreement is impracticable in the short term. It is possible that it might be possible to reach more specific agreements with selected producers in the Gulf, under the cover of wider discussions.

28. In making any kind of bargain one needs to ensure that the other party will uphold his end of it. One would need ideally to arrange the details of a package in such a way that the obligations are mutually dependent. At the end of the day however, we would need to recognise that there is little we can do to protect ourselves against the consequences of major political developments in the oil producing countries, which could negate any agreements we might have reached. Thus any negotiations with them will have to be cautious, exploratory and without commitment.

POSSIBLE STEPS TOWARDS AGREEMENT

29. The best approach seems to be to aim for a gradual extension of contacts with oil producers whenever opportunity permits. We should not confine ourselves to any one forum to the exclusion of others but display a readiness to participate in any exchanges on energy. At the moment, the only discussions definitely on offer are in the Global Negotiations. Whatever our general misgivings about the Global Negotiations, we should do what we can to make progress on the energy side. We should use them to improve the general climate, and to try to reach a general understanding about the general problem we all face. The discussion should be wide-ranging so as to allow for an exchange of views on supplies and prices. This will enable us to underline the theme of interdependence. If discussion were to lead to agreement for a more permanent energy body that would probably be valuable. We should in the meantime examine further the scope for an approach to individual Gulf producers or to the Gulf as a whole. At the same time we should not exclude the possibility of working out in an OECD context some general propositions which OPEC might regard as worth pursuing.

CONCLUSIONS

30. Until the 1990's, the OPEC countries will have a stranglehold on the West's oil supplies. The time needed to develop the production of other energy supplies and to make significant gains through conservation makes that inevitable. If the OPEC countries were to exploit to the full their ability to raise oil prices the consequences for the world economy could be catastrophic. It is not sufficient to sit back and hope for the best; the West has to make a positive attempt to influence OPEC policies. Part of this effort should be in the political field. We should go to considerable lengths to foster our relationship with those oil producers which regard Western support as important to their own security, but not in such a way as to cause them embarrassment. We should seek to convince the Arabs that we are making genuine efforts, within our potential, to achieve a settlement in the Middle East; and we should also discreetly encourage the many developing countries which have been seriously affected by recent sudden and large oil increases to exert such diplomatic pressure as they can in favour of greater restraint by the oil producers.

An essential element will be visible and effective progress in putting our own energy house in order. We could thereby reduce the demand for oil and perhaps exert some marginal pressure on the oil producers by demonstrating that their position will not be impregnable for ever. But such efforts would not necessarily be enough to prevent further damaging price shocks or sudden interruptions of supply. It is therefore for consideration whether we should seek an agreement or understanding with some or all of the oil producers under which they would trade responsible behaviour for concessions on our part. We would have to accept, of course, that no such understanding would be proof against major adverse political developments in the Middle East. Unfortunately this is also an area in which we have very few cards to play. In particular the question of providing some form of indexed assets raises severe practical problems and may be quite unacceptable to our industrialised partners (particularly the US and Germany). And we can do nothing without them. It seems clear that there is no chance of reaching an early formal agreement with OPEC

which could be made to stick. Thus the issue is rather whether Ministers feel that it is worth a major effort to see whether the existing pattern of contacts with the oil producers can be put onto a new set of tramlines, which at least move towards an understanding with some or all producers in the longer term. The start of such an effort might be an indication by OECD or Summit countries in general terms that they are ready in principle to pay a price in other areas in return for satisfactory oil supply and pricing policies by the OPEC countries.

31. Ministers are therefore invited to consider:-

i) whether, in the light of the risks, and attendant potential benefits, they would like officials urgently to explore, without commitment, with our major OECD partners (the "Summit"countries), their likely attitude to the various elements in an approach to the oil producers discussed in the paper.

ii) if so, whether there is any guidance they wish to give for these official discussions on the relative weight to be attached to these elements, as detailed in Paras 11-24 of this paper, or whether any elements should be excluded.

iii) whether they feel that until the results of this work are known and reported to Ministers, there should be no indication to the oil producers of any change in our existing stance.

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PREVIOUS DIALOGUE WITH THE OIL PRODUCERS.

1. In the aftermath of the massive price increases of 1973-74 a good deal of international consideration was given to possible ways of avoiding future upsurges in time. This dicussion proved largely sterile, not least because of the political as well as the technical difficulty of formulating a "deal". Even such procedural initiatives as were contemplated, eg the EEC/Gulf discussions never really got off the ground. In the middle '70s the slackening in the pace of price increases led to a reduced sense of urgency about the need for effective consultations. In 1979, the revolution in Iran caused a scurry for supplies which provided the impetus for a furthermajor price surge. These events have been marked by increased disarray in OPEC's pricing structure, with Saudi Arabia being unable to impose its moderating influence. More recently significant new developments have been -

(i) evidence of the willingness of some other OPEC countries to maintain their higher price levels by production cuts, and

(ii) discussion in OPEC of a formula for automatic price increases.

2. There has been no formal dialogue on energy between producers and consumers since the end of CIEC in 1976. No agreement was reached in those discussions on the consumers' proposal for a continuing energy dialogue and since CIEC consumer/producer contacts have been on a purely bilateral basis. The Euro/Arab dialogue had a sub-committee which discussed certain technical energy questions but did not cover discussion of supply and prite.

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3. Renewed interest in proposals for producer/consumer dialogues was stimulated following a Saudi communiqué of February 1979 which cal for rapid consultations between exporting and consuming countries to rationalise oil consumption, to stabilise prices and to avoid damage to the world economy. The European Council welcomed the communiqué and the French Industry Minister visited Saudi Arabia i March to convey this favourable reaction. The Saudis made clear that oil prices could not be subject to discussion but that a dialogue on general energy supply questions might be possible. Th only outcome however was a low-key technical exchange between Shei Yamani's OPEC Strategy Committee and a team from the European Commission which took place in London in June 1979.

4. 1979 saw a number of other proposals for producer/consumer contact The Venezuelans continued to pursue their suggestion for an OPEC/ OPEC meeting (including the UK), but evoked no enthusiasm from oth OPEC countries. The Mexican proposals for a world energy forum ha similarly been opposed by OPEC. In February the European Communit Energy Commissioner proposed a new consultative committee of producers and consumers to be established outside IEA auspices: th idea sank as soon as it was aired. Also in February the Iraqi Oi Minister called for the establishment of closer economic contacts between consumers and producers of oil. The Norwegians proposed a quadrilateral meeting (UK, Norway, Venezuela, Saudi Arabia). Th ideas have not got anywhere. The most recent initiative was the Kuwaiti/French proposal in June for an EEC/Gulf energy dialogue.

5 But these proposals have still not come to anything. The OPEC long term strategy Committee which met in London in February, recognised that a dialogue was "inevitable" and proposed that it should be on an OECD/OPEC basis. But it is far from certain that OPEC Ministers, later this year, will endorse theidea or do anything to give in political impetus. The only immediate prospect for a multi-lateral discussion of energy issues therefore remains the energy aspect of the global negotiations due to begin within the UN framework later this year or early next year.