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Atw. / Any comments? – file JV. 8/1

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Your reference

Our reference

Date
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Dear John,

OIL TANKER DRIVERS: CONTINGENCY PLANNING

I followed with interest the recent correspondence between Desmond Carr and yourself about the role which market forces might play in distributing oil during an oil tanker drivers' strike. We spoke about this last month, when I said that in preparation for the CCU meeting on 19 November I had consulted our economists on the use of the price mechanism under these circumstances. In the event, Bill Moyes told me that the intention was to pursue this aspect separately, and not at the CCU meeting. Subsequent to the meeting, he told me that discussions would in the first instance be taking place between yourself and the Department of Energy, and that any Treasury points might best be injected into that discussion. That is the purpose of this letter.

2. We agree that distortions and difficulties will arise if the allocation of scarce oil is left to a central directorate. But it should not be assumed that allocation by price would avoid distortions and difficulties which, although rather different, might be no less than those caused by administrative allocation. We are not referring here to wider political aspects on which Ministers, including Treasury Ministers, will no doubt have their own views. We are referring simply to the probable failure of the price mechanism, in the circumstances envisaged, to achieve the optimum allocation which it should in principle provide.

[illegible]

3. Economic theory states that in the perfect competition paradigm the price mechanism will produce such an optimum allocation. But with few exceptions, the theorem ceases to apply when an economy deviates from an instantaneously clearing, perfectly competitive market in which all participants have perfect information.

4. In the case of a temporary shortage of oil delivery services the following serious departures from the paradigm would be important:

(a) <u>no efficient means of distribution</u>. I mentioned this point when you first raised the matter. By definition, it is part of the problem. But the price mechanism could not be expected to solve it. With the available tankers requisitioned by the army and fully engaged in primary distribution, there would be inadequate physical means for redistributing large quantities of oil in response to price signals, and those there were would be inefficient, not least in fuel. To illustrate, the inevitably sub-optimal pattern of distribution by the army might cause petrol in Leeds to be twice the price of petrol in Manchester. In the absence of bulk transport, however, it might be found that the response to this price signal took the form of cars choking the M62 to get petrol in Manchester (wasting scarce fuel in the process) rather than an efficient redistribution of supply between the two cities. Of course the army could try to respond to price signals by concentrating deliveries where prices were highest. But I suspect that their arrangements (which are themselves part of the central bureaucracy rather than the market) would not have the necessary flexibility.

(b) Lack of information. Distributors would have imperfect information about supplies and about the level of demand at any given price. Even what might seem a longish strike would be a relatively short period for them to learn, given the large size of price adjustment which might be needed and the possibility that supplies would fluctuate. Consumers, for their part, would not necessarily be aware of the cheapest available supplies at any given time. In the circumstances, it is most unlikely that the prices set will be optimal; and the allocation of resources will, as a result, not be efficient.

(c) Participants in the market. Here again, there would be serious departures from the free market model. The monopolistic or oligopolistic nature of decision-taking in large sectors of the market is an obvious example. Furthermore, a considerable proportion of the demand for oil comes from public sector concerns where decisions are not necessarily based on the strict commercial criteria of economic theory (for example the National Health Service). This will mean that the market clearing price does not reflect the marginal gain to the buyer across all sectors of the market, and the resulting allocation could not be said to be efficient either in economic terms or in terms of the value put by society on the alternative uses.

(d) Adjustment problems. Markets take time to adapt to new situations, and in general there are costs associated with the movement from one equilibrium to another. Adjustment costs to much higher oil prices would be incurred throughout the economy. These might be negligible compared to the long term benefits if the change were permanent; but they are likely to be considerable compared to any benefits which might follow the adjustment to the new equilibrium for a temporary stoppage.

5. The attraction of the price mechanism is that it should in principle achieve an optimal allocation. Even if it did, Ministers would want to weigh this against such factors as public sensitivity

to the high prices which might result. But for the reasons which I have given, we doubt whether the price mechanism would in practice achieve an optimal allocation during a relatively short but severe reduction in supplies. Our feeling, therefore, is that any report to Ministers on this subject should recognise that the choice between administrative and price allocation is a choice between different kinds of distortion rather than between distortion and no distortion.

6. I am copying this letter to Desmond Carr and to Bill Moyes. Perhaps I could take this opportunity to notify the latter that we have no comments on CCU(82)51.

Yours sincerely

Tim Burr

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IC Division