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CONFIDENTIAL

PRIME MINISTER

Oil Prices and Supply
(E(80) 137: UKREP Brussels Telegrams 5152, 5153 and 5173)

BACKGROUND

Up to the outbreak of the Iraqi/Iran war oil supplies were above the then current level of world demand and spot prices were weak, despite the fact that Iranian output was well below pre-revolution levels, because of the substantial reductions in demand brought about by the world recession. The Gulf war has now reduced supplies below demand by virtually shutting off all exports from both Iran and Iraq. Increases of output from other suppliers, notably Saudi Arabia, have made good part of the shortfall, and world oil stocks are high. Nevertheless there is much nervousness among consumers, and spot oil prices have risen. The danger is that uncertainty, particularly about the duration of the Gulf war, could exert continuing upward pressure on prices and thus deepen the recession. There has already been considerable discussion in both the IEA and the EEC about the steps which consuming countries might take to reduce the risk of a further rise in the price of oil. Three key meetings are due in the next fortnight - the EEC Energy Council on 27th November (Mr. Howell attending for the United Kingdom); the European Council on 1st December; and the IEA Governing Board, at Ministerial level, on 9th December (again Mr. Howell attending).

2. A further increase in the price of oil would be a disaster. The question is what, if anything, can, or should, consuming countries do to prevent it happening? There are a range of possible options, namely:-

(a) To "trigger" the IEA's general oil-sharing mechanism. Unlikely to be widely advocated, because such action is generally seen as out of scale with the nature of the problem (which is really one of a marginal imbalance between demand and supply), as a new and inappropriate use of the mechanism (designed to cope with supply difficulties, not to influence price), and as risking the integrity of the system.

(b) To "trigger" the IEA sharing mechanism on a selective basis, for the benefit of the relatively few countries who face real and immediate supply difficulties, e.g. Turkey and Portugal. The IEA Secretariat (with whom formal responsibility rests) have fought shy of this solution perhaps because, as matters stand, it would largely require American oil companies (flush with oil from Saudi Arabia) to take the main action.

(c) To impose "import ceilings" on consuming countries. The Foreign and Commonwealth Secretary may suggest that we should go along with this course if, as appears likely, the Americans advocate it. But other countries are less happy. The negotiation of actual ceilings could be a time-consuming and difficult process; and once established the ceilings could provide OPEC with a ready-made production target to the disadvantage of the West.

(d) To run down stocks. These are high, and a rundown in stocks is a classical reaction to a short-term supply difficulty (indeed the stocks are held for just this purpose). The trouble here is not to agree that a stock rundown would be a sensible course of action - the IEA has already done so - but to give effect to the decision. Stocks are for the most part owned by the oil companies, and they can be expected to want to hang on to them, particularly if they see a price rise in the offing.

(e) To cut consumption. It would, in fact, be hard to secure worth-while cuts, and to try and do so would be hard to sell to United Kingdom public opinion given the North Sea. But Mr. Howell advocates acceptance of a modest restraint of demand, without saying what he means. The danger is that one risks maximum problems for minimum gain.

(f) To minimise purchases on the spot market. This is sensible, but may be a counsel of perfection so long as individual companies, countries and consumers are hit differentially by the loss of supplies from the Gulf. Action by the "crude rich" United States companies to ease local difficulties would enable the line to be held - though it must be uncertain whether the United States Government could deliver the companies in this way (they have not managed to do so thus far).

3. The flow of telegrams from Brussels preparatory to the Energy Council meeting on Thursday illustrates the forces at work. A day or two ago the Commission (Davignon) were preparing to recommend that the Council should favour oil import ceilings. They now appear to be going cold on this, and the present draft conclusions are largely a restatment of existing agreed aims.

4. The main issue is whether the approach set out in Mr. Howell's minute to you of 17th November (and subsequently repeated in his paper E(80) 137) represents an adequate response to the threat. E Committee should say whether they agree with Mr. Howell's preferred low profile and how far, if necessary, he can go. It will also be important to ensure that the EEC line (including the French) is not too much at odds with that which emerges from the IEA in December (when the French will not be present).

HANDLING

5. You might invite the Secretary of State for Energy to introduce his paper and to bring the Committee up to date on subsequent developments. The meeting can then be thrown open to general discussion.

CONCLUSIONS

6. These are particularly difficult to forecast because the perceptions of colleagues of the scope and need for action can vary widely. It will be particularly important however to recognise the linkage between the three meetings - Energy Council, European Council, IEA - and the overriding need for the Western countries to emerge from Paris with a united front. The presence of the French at the earlier meetings, and their absence from the IEA, means that the Energy Council and the European Council provide the opportunity to get the French on board. On the other hand, Mr. Howell will need to be careful not to accept commitments in Brussels which could create problems later with the Americans and the Japanese. This may not be easy to achieve,

given the uncertainties about what the Americans really want and the natural desire of the EEC countries to stick to their own line once they have agreed. But the effort must be made.

7. It might also be sensible to envisage calling a further meeting of E if this proves necessary, to look at the issues once again between Luxembourg and the Paris meeting of the IEA.

D J Wright

~~(Robert Armstrong)~~

(approved by Sir R Armstrong and signed on his behalf).

25th November 1980