

**A Dialogue Between Oil Producers and Consumers:  
The Why and the How**

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Responsibility for its contents is, however, entirely mine.

Robert Mabro

## EXECUTIVE SUMMARY

Interest in a dialogue between oil-producing and consuming countries has recently been revived by a joint Franco-Venezuelan initiative convening an inter-governmental seminar in Paris on 1st and 2nd July, 1991.

This Oxford Institute for Energy Studies (OIES) report, *A Dialogue between Oil Producers and Consumers: the Why and the How*, addresses in a free thinking way the issues which lie behind this interest in a multilateral approach to the energy problem, assesses regional and bilateral strategies which are proposed by other parties as alternatives, and suggests an agenda for inter-governmental discussions.

We argue that a distinction needs to be made between a dialogue and a binding international agreement. The dialogue should be conducted with an open mind and the aim of finding out whether multilateral arrangements are relevant to the solution of the problems at hand, not with the intention of negotiating from the start such an agreement.

The problem is defined as oil price instability together with its corollary, sharp variations in the revenues of developing oil-producing countries. Two types of instability are distinguished; the first refers to discontinuous and significant changes in the oil price level, and the second to normal day-to-day market fluctuations. In the past twenty years oil prices moved from one to a very different level on three occasions as a result of shocks. Some are caused by political disturbances; some by economic behaviour, either the investment cycle or aggressive competition for market shares; some by both.

The effects of big shocks are often very damaging. They can cause economic recession in the world at large or destabilize oil-producing countries in the third world. Shocks due to political disturbances cannot be avoided by means of international energy policy; shocks caused by economic factors are avoidable; and in both cases adverse effects can be significantly mitigated.

Can the oil market help in this respect? This report argues that the market plays a very useful, yet imperfect, role in allocating resources in the short run but is unable to provide appropriate price signals for investment decisions that influence the oil supply/demand balance in the long run.

Peculiar features of oil economics, namely a very low cost floor for crude oil production and a very high price ceiling set by substitutes, mean that the setting of an oil price level is a fairly arbitrary affair. As the market does not get much guidance from economics on where the level should be, it seeks cues from elsewhere.

Although nobody should interfere with the market, other than removing imperfections, and leave day-to-day price movements entirely to its operations, the

question arises as to who should provide it with the signal about a desired price level?

The thesis therefore is that the role of the market needs to be supplemented by another mechanism in two areas: one that improves the flow of economic information necessary for good investment decisions and one that provides indications to the market about a level around which prices can fluctuate freely up and down in response to short-term economic forces.

That policies or strategies need to supplement or provide an improved framework for the operations of the market seems to be widely, albeit implicitly, recognized by governments which promote such schemes as national energy strategies in the Energy Charter for Europe or special bilateral relationships in energy.

The report briefly reviews these schemes and finds that the US national strategy is a non-strategy, that the Lubbers' Plan is essentially a proposal for a bilateral deal between Western Europe and the Soviet Union over the use of Soviet reserves and that ideas for a special US-Saudi relationship, despite their other merits, do not provide an answer to other countries' concerns.

All this leads to the conclusion that there are important issues to explore by the interested parties, hence the case for a dialogue. Strong US opposition to the whole concept casts a very dark shadow over the Franco-Venezuelan initiative. Because of this opposition and other drawbacks the expectations surrounding the Paris meeting are low. In the circumstances this may be a blessing in disguise, because a partial failure or an inconclusive outcome will not be perceived too much as a disaster. The risk involved in the Franco-Venezuelan initiative is that a perceived failure of the Paris meeting may kill the idea of a dialogue for many years to come.

Should the dialogue proceed without the USA? The answer is yes if the approach adopted is to explore issues of mutual concern to producing and consuming countries without prejudgment as to the nature of possible solutions. The Paris meeting should establish commissions for undertaking the research and discussions needed to clarify issues selected for serious investigation. Good work may provide compelling reasons for seeking multilateral solutions to some problems, and the force of reason may then persuade the USA of the merits of the approach.

We propose an agenda for this dialogue. It includes a study of:

- (1) schemes involving both the creation of a surplus capacity cushion in a number of oil-exporting countries and strategic stock in a number of oil-importing countries;
- (2) measures to improve the functioning of the oil market;
- (3) possible ways for establishing better information flows in investment;

- (4) the issue of re-integration of the oil industry in ways that bring into the open the many suspicions of industrialized and oil-producing countries about the intentions of those who advocate access to their industrial sectors or resources;
- (5) the question of the oil price level.

The report suggests that the environmental issue should not be put on the agenda at this stage because its inclusion risks to divert the dialogue away from its central purpose; and that the price issue *as defined here* should be addressed at some stage.

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## 1 INTRODUCTION

The notion that a dialogue, leading to co-operation between oil-producing and oil-consuming countries, may either avert oil shocks and excessive price instability or, at least, mitigate their adverse effects emerged early on in the 1970s. The very few observers who predicted the 1973 oil shock a year or two before its occurrence also sensed that the impending crisis would not be rapidly solved by smooth market responses and short-term economic adjustments. In their judgment the dramatic situation that was going to develop with dire consequences for the welfare of oil-importing nations called for a political solution.

They differed however on the nature of the solution as some were inclined towards a confrontation that would impose the will of industrialized countries on the third world oil producers and constrain the use of their monopoly power, while others favoured a search for co-operation.

This division sharpened when the crisis occurred in 1973. Henry Kissinger threatened confrontation. He argued that the actions of OPEC could cause the 'economic strangulation' of the West and constitute a *casus belli* if they were carried any further. (One may recall with sad irony that the same argument was used by Saddam Hussein years later to justify his intolerable aggression against Kuwait.) But Kissinger who mentioned only once the possibility of military action did not resort to such a drastic solution. He opted instead for defensive measures: the creation of the IEA and the curious proposal, never adopted, that consuming countries should erect a floor (at \$7/barrel) under the price of internationally traded oil. His fear was that market forces might eventually bring about an oil price collapse that would stimulate energy demand, discourage investments in nuclear, coal and gas and aggravate therefore Western dependence on oil imports from the troubled and troublesome Middle East.

Others, however, wanted to explore avenues for co-operation; and promoted the idea of an international North-South dialogue. A conference, known as the CIEC, was convened in Paris in December 1975. Most OECD countries wanted to limit the agenda to oil issues while OPEC insisted that the brief should encompass all important North-South economic relation problems, fearing that a narrow focus on oil would drive a wedge between oil producers and the rest of the third world. The conference failed partly because the broad agenda was unmanageable, partly because the OECD countries had by then regained their confidence realizing that OPEC's power was after all limited, and that the damages caused by the oil shock were not so great as to justify costly concessions to the South on a wide economic front.

The CIEC failure killed for a long time the concept of formal multilateral negotiations between governments on the energy issue. Some continued to believe however that much ground work could be done through private or semi-official initiatives to improve the understanding that governments, companies, policy

makers of oil-producing and oil-consuming countries had of their respective positions and interests.

In a modest way Oxford played a part in this context through the Oxford Energy Policy Club founded in 1976 and the Oxford Energy Seminar which held its first annual session in 1979. The OPEC secretariat also organized international seminars in 1977-81 in view of 'continued dialogue with the industrialized, consuming nations'. In the same period, ENI, the Italian national corporation collaborated with OAPEC in an ambitious project to foster economic co-operation between the Mediterranean countries of Europe and the Arab world. The initiative consisted of an important seminar, 'Development through Cooperation', held in Rome in April 1981 and the joint undertaking by ENI and OAPEC of a wide range of studies to identify ways of increasing inter-dependence between Europe and Arab countries and assessing the economic benefits of enhanced relationships.

There is no doubt that these and other similar endeavours improved to some degree mutual understanding. They helped in removing certain psychological barriers, dispelling some damaging misconceptions and irrational fears. But private and informal initiatives in this field can only contribute to a change in climate. To go further requires the forging of political will in the official sphere.

A formal dialogue, that is multilateral negotiations between sovereign states, is only possible when the parties on *both* sides of the exporter/importer divide each faces serious problems which they wish to solve. The incentive to seek a dialogue arises from the recognition that agreed international measures may ease these difficulties and provide benefits to both parties. In most instances, however, there is asymmetry: one party finds itself in a weak position and the other feels either that it has the upper hand or that the problems faced are not sufficiently serious to warrant the trouble of a complex endeavour.

There was some expression of interest in a dialogue by a few industrialized countries in the mid-1970s and in 1979-80 when OPEC appeared to be a powerful and threatening entity. At these particular times the producers were not very enthusiastic about these ideas. In the 1980s when the world petroleum market was glutted and prices falling, OPEC developed a strong interest in the dialogue and the industrialized countries were generally unconcerned.

To be sure, there always were some differences in views within each group. France, Italy (ENI rather than the government), some Scandinavian countries never rejected out of hand the idea of a possible dialogue. Japan, always concerned about the security of supply, would consider the idea if it had the blessing of the USA which, alas, was never forthcoming. In the Reagan-Thatcher era neither the USA nor the UK would even contemplate any initiative in this area; and Germany took the view that it could always obtain oil, even in a crisis, simply by paying the price. Germany felt sufficiently wealthy to be able to survive oil price crises which, in any case, neither occur very frequently nor last for very long.

Within OPEC, strong expressions of support for a dialogue between oil consumers and producers were often formulated by ministers from Gulf countries during the 1980s. Algeria, Libya, Iraq and Iran, depending on political circumstances, were at times antagonistic, at others indifferent or lukewarm. Towards the end of the 1980s OPEC as a whole became more vocal on this issue. The Secretary-General, Professor Subroto, adopted the co-operation theme and argued the case in virtually all his public appearances. At the same time the President of Venezuela committed himself to the idea and engaged in vigorous efforts to embody it in an international conference.

The Gulf crisis of 1990-91 opened up a new chapter of this protracted and rather uneventful history. Wars often elicit a yearning for a new order in which peace will be firmly established on the solid foundations of international co-operation. And those who lead wars need to convince their people, many of whom may die, not only of the justice of their cause but of a better future. There must be a promised land of milk and honey at the end of the journey. And since the Gulf war was not one of conquest for the US-led coalition, the promises related to the establishment of a 'new international order'.

The USA was probably thinking of an order in which security in the Middle East would be enhanced by finding solutions to such intractable problems as the Arab-Israeli conflict and by creating new regional alliances. Some European countries, and France in particular, thought that any new order involving the Middle East must include a dialogue and a modicum of co-operation on oil.

For different reasons, and from different starting points, there was a meeting of minds, a convergence of interests between France and Venezuela on the need for an initiative which will bring around a table government representatives from oil-producing and oil-consuming countries for a dialogue on energy. The issue, for the first time since 1976, is formally on the international agenda.

But what precisely is the issue? Can it be defined in ways that reveal operational significance? And if so, how should the dialogue be pursued to provide a framework both for understanding and action? This paper is an attempt to answer these and a number of related questions.



## 2 THE ENERGY PROBLEM

The need for a dialogue with a view to eventual agreement or co-operation between two parties arises

- when each of them faces problems caused by the actions or policies of the other party, or both face common problems caused by external factors;
- *and* when there exists a belief that these problems cannot be easily solved (or that their effects cannot be significantly mitigated) by each party acting on its own or through the autonomous operation of market forces yielding rapid and relatively painless adjustments.

In other words, there must be problems for both parties (perhaps of a different nature) that cause or threaten to produce significant damages (perhaps to a different degree) to all of them. These problems must be interdependent in some fundamental respect. There must be an awareness of these problems and their possible implications and some shared conviction that autonomous attempts to solve them by each party, or exclusive reliance on exogenous forces still leave something to be desired. When these conditions are satisfied, it becomes legitimate, indeed rational, for all parties to raise and attempt to explore the issue of co-operation.

To begin with, let us define the nature of the energy problems that face oil-exporting and oil-importing countries. The simplest definition relates to shocks. On three occasions in the past twenty years, the price of oil in international trade changed suddenly and significantly. In 1973-4 the price quadrupled in the space of three months; in 1979-80 it trebled over a nine-month period. And between January and July 1986, the price of oil collapsed to 30 per cent of its initial level. On two of these occasions, and in another episode in 1990, there were supply disruptions associated with dramatic political events in the Middle East: an Arab-Israeli war in 1973, the revolution in Iran in 1979, and the invasion of Kuwait by Iraq in 1990.

Political crises in the Middle East are not always associated with significant oil price rises. There was no price explosion during the eight-year long Iraq-Iran war; on the contrary oil prices were declining during most of this period, and at one point did indeed collapse. Oil prices rose during the 1990 Gulf crisis but the increase was twofold as compared with the three- and fourfold rises that obtained in the 1970s; and this relatively minor shock was of short duration.

The chronological coincidence of certain oil shocks with major political events in the Middle East has tended to confuse perceptions of the respective role of economic and political factors (and of their interdependence) in bringing about sudden and significant oil price changes. The distinction is of extreme importance in this context however. The political factors that contribute to the emergence of an oil crisis, and influence the subsequent responses of the parties involved

require different approaches to their solution, and then different remedies, than the economic factors which may cause price instability.

The 1973 shock is of particular interest in this respect. It was, and still is generally perceived as a politically-induced shock due to (a) the imposition of an embargo by Arab oil producers in a conflictual situation with Israel and its main supporter, the USA; and (b) the emergence of a powerful cartel of oil-exporting countries in the third world. There was indeed an Arab-Israeli war and an embargo. And there was a change of hands in the game of oil price determination, as the master card - that which bestows the right to set prices - passed from the major oil companies to OPEC. But there was also an economic factor of considerable relevance: a constraint on productive capacity upstream at a time of fast growing demand. The capacity constraint did not emerge as a result of restrictive practices on the part of OPEC because in most member countries the investment decisions were made by the foreign companies, not the host governments. To be sure, the companies invested on a large scale throughout the period leading to the 1973 shock but in the late 1960s these investments, large as they were, failed short of the amounts required, first, to cater for a relentless, almost unbelievable, increase of 7 per cent per annum in oil demand, and secondly to ensure the continued existence of a safe cushion of surplus capacity. The problem is that a high though constant rate of growth translates into larger and larger *absolute* increments in demand, therefore in capacity requirements; and that the unabated persistence of such a rate of growth over a long period of time (in this case from the late 1940s to 1973!) causes these increments to become huge. A small misjudgment on the percentage increase of new capacity required could well result in a large absolute shortfall.

The lesson of the 1973 shock, once the interpretation of this critical event is stripped of myths and prejudices, is that problems can be caused by three different types of factors: political disturbances, price administration systems and investment behaviour. A myth and a prejudice stood for a long time in the way of a correct interpretation. The myth, prevalent in the 1970s, now fortunately dead, was invented by the Club of Rome which argued that the world was running out of natural resources. Many believed therefore that the economic dimension of the 1973 shock related to an impending shortage of reserves (hence the considerable interest generated ever since among economic theorists on issues of depletion and exhaustibility). In reality the economic aspect was one of a mismatch between investment and demand growth, a mismatch that is difficult to remedy in the short or medium term because of the fairly long lead-in times that characterize investment projects in the whole field of energy. The prejudice, of course, was that the crisis was entirely due to a *mischievous* exercise of monopoly power by OPEC. Of course, OPEC was at the forefront and used its power to set the price of oil at a much higher level than the depressed \$2-3/barrel in nominal terms which had ruled for so long before. But the new price levels were lower than would have obtained in a market setting considering the supply/demand balance and the political uncertainties of the time. And the monopoly advantage was not pushed at all after the initial shock as prices were

left to stagnate in nominal terms for almost five years, from early 1974 to late 1978.

The 1979 shock was different in some important respects. Oil supplies were disrupted by a revolution, *not* by punitive actions from some exporting nations involved in an international political dispute with other countries that happened to be oil importers. Considerable and disquietening uncertainties about the future course of the Iranian revolution and the possibility of its spreading to other Gulf oil-producing countries played a major role. There was also a major disturbance in the pattern of oil trade because BP and Exxon suddenly deprived of their access to Iranian oil had to serve '*force majeure*' notices to their Japanese, and to some European, customers who rushed, in a state of justifiable panic, scrambling for direct supplies from OPEC countries. Uncertain about whether they would obtain the volumes needed they bid everywhere for amounts that added up to more than their initial requirements. These buyers' policy was 'play it safe even if the costs turn out to be high, just in case we cannot obtain what we used to get'. Many ended up purchasing more than initially required. *Ex ante* demand inflated by the response to '*force majeure*' dislocation of established supply channels, expanded further because of an increased inventory demand for precautionary motives. Finally, there was a price distortion paradoxically caused by a policy of price restraint adopted by major OPEC countries, particularly Saudi Arabia. In 1979 official prices set by OPEC lagged well behind the spot markets. Some countries imposed temporary premia to close the gap; Saudi Arabia continued to supply the Aramco partners and others at the lower prices creating the famous 'Aramco advantage' which naturally led the four partners (Exxon, Texaco, SoCal and Mobil) to lift as much as possible at these favourable prices.

In short the 1979 price shock was due to normal buyers' responses to (a) supply disruption resulting from a dramatic political event, and (b) price distortions arising from genuine, if unenlightened, attempts to calm markets in a state of excess demand by holding prices down. At a critical moment in 1979 there was also an unfortunate misjudgment when Saudi Arabia re-imposed a production allowable at a time when Iranian production had begun to increase. The misjudgment was about the strength of buyers' appetite during this crisis.

The main lesson of 1979-80 is that little can be done in a situation when excess demand emerges after a supply disruption other than redirecting oil flows swiftly from surplus to deficit areas and making up for the residual deficit by releasing strategic stocks. There is no doubt that successful action along these lines requires effective international co-operation either between consumers (hence the IEA) or preferably between consumers and producers, as well as the availability of stocks. To tamper instead with prices, even with the best goodwill in the world, is fatal in these circumstances as every economist knows. One suspects however that the moderate price policy followed by Saudi Arabia and one or two other countries was not due to a lack of economic understanding but to a political factor: to avoid antagonizing the USA which was advocating moderation. It was the USA, the staunch advocate of the primacy of the market, that seemed to have failed to understand that no cartel can fix and hold prices *below* the

clearing market level in the face of excess demand. Cartels may be able to hold prices *above* the equilibrium level when there is excess supply by withholding production, and only then, if they are disciplined, can they go against the market. But this, of course, is another story.

The 1986 crisis was one of a price fall, and was therefore a shock for producers. Politics, but of a different nature, was involved to a certain degree. There was neither a revolution in an OPEC country, nor an international conflict between sets of oil-consuming and oil-producing countries. The politics was that of the relationships between oil-exporting nations both within and outside OPEC. The situation facing the organization was difficult to manage: to hold the price line after a collapse of the demand for OPEC oil of some 45 per cent (from 30 down to 16 mb/d) cannot be achieved when the majority of the group expects two or three of their members to carry a very large part of the production cut burden. At first sight it may seem that the oil price collapse of 1986 was brought about by Saudi Arabia's action to regain market share. One needs, however, to take one step back and ask why Saudi Arabia was pushed in desperation into launching a price war? It was indeed the failure of non-OPEC producers and many OPEC member countries to realize that their persistent and self-defeating refusal to share in the burden of production restraint on the false assumption that 'Saudi Arabia had no choice but to oblige' would lead to such significant reductions in Saudi sales as to make it impossible for the Kingdom to continue the price support policy.

The first important lesson of the 1986 crisis is that the price of oil can indeed fall to the abyss if producers engage in aggressive competition one against the other in a situation of excess supply. And the second lesson is that very low oil prices damage wide ranging and powerful interests, not only within OPEC, but outside it. All countries, including net oil importers, have domestic energy industries - nuclear, coal, gas and domestic oil - to protect. The USA in particular is not only the world's largest consumer of energy, and the largest importer of oil but a very major producer of all types of energy including petroleum for which it ranks second in the world producer's league. The oil companies outside the OPEC region have investments in high-cost oil and gas to defend. And those consuming countries, such as Japan, that worry about the security of supplies over the long term, and understand that low prices not only do stifle the investments required to sustain increasing oil flows but can also destabilize politically some major oil-exporting countries, tend to worry when oil prices fall to very low levels.

The forces that oppose a low oil price state of the world are very powerful indeed. They are much stronger than the parties which derive from it unmitigated benefits: final consumers in the countries where governments do not compensate for a fall in crude oil prices by increased taxation on petroleum products, and small oil-importing developing countries. And it is significant that the effective intervention that arrested the price collapse of 1986 and sought to bring the price level up to a moderate \$18/barrel was made by Vice-President Bush complaining to Saudi Arabia about 'irresponsible policies' that threatened the strategic interests of the USA. The worry, in the context of super-power rivalry, was that low prices would increase US oil-import dependence and weaken its strategic

position *vis-à-vis* the Soviet Union, a major net exporter. Once again, the USA set aside its professed belief in the value of an unhindered market subject to strong competitive forces in favour of discreet but effective intervention.

The Gulf crisis of 1990-1 is of considerable interest in this context. There was a small and temporary oil shock. Oil supplies were suddenly curtailed by some 4.5 mb/d following the imposition of an embargo on exports from Iraq and Iraqi-occupied Kuwait by countries that happened to be major oil importers. There was, of course, an immediate and significant price increase, but the threat of a very major price explosion was dampened by the rapid utilization of an unsuspectedly large amount of surplus productive capacity in Saudi Arabia, Abu Dhabi and smaller amounts elsewhere, in some OPEC member countries, Mexico and Australia. This enabled IEA countries to hold back on the use of strategic stocks, keeping them in reserve until the outbreak of military hostilities should these cause a further supply disruption.

Other factors, some fortuitous, some policy-related, did also help. A recession caused by economic developments which preceded, but was no doubt made more severe by, the Gulf crisis reduced oil demand at a time of tight supplies. US oil companies which happened to hold large crude oil inventories in August 1990 and chose to draw them down steadily throughout the crisis, in sharp contrast to their behaviour in the 1979-80 episode, did much to release pressure from the market.

The lesson of the Gulf crisis is that the existence of surplus productive capacity in the world system - the missing feature in 1973 and 1979 - is the best antidote to the adverse impact of supply disruptions. Strategic stocks, which curiously were not used in this nor in preceding crises, come second in importance. Their existence provides some psychological reassurance; but their real effectiveness crucially depends on the policies which govern their release. It is not difficult to imagine situations where, for lack of sensible policy, famine breaks out around overflowing but sealed grain silos. The main difference between strategic stocks in an importing country and surplus capacity in exporting areas is that the former will add to supplies in the owning country only, while oil from surplus capacity can be directed virtually everywhere.

Many argue that the Gulf crisis has shown that markets can handle a supply disruption remarkably well. It is said that the difference between the 1979 crisis and the Gulf affair is that we did not have much of a market in the former and a very sophisticated one in the latter. This is not true however. There was no surplus capacity in 1979 to cope with increased *ex ante* demand, but sufficient amounts of slack in 1990 to make good a local but major disruption in supplies. And there was, in the proper economic sense of the term, a real market in 1979, meaning an interface between a multitude of buyers bidding for physical supplies from a number of producers. Demand for the marginal physical barrels led price movements. In 1990 the market included on top of these transactions a wide array of trading instruments. Whether the use of these instruments tends to

dissociate price movements from the bids at the physical margin for a barrel and increase price volatility is a moot question which cannot be easily answered.

The experience derived from four crises, admittedly of varied severity, in less than twenty years enables us to identify fairly easily some of the features of the 'oil problem'.

- (1) The world petroleum system is vulnerable to major supply disruptions caused by civil commotions in major exporting countries, by international conflicts between some of these countries and Western powers, and by regional wars involving directly one or two oil-exporting countries.
- (2) Under-investment in capacity can cause a price explosion. As investment gestation lags are typically long in energy industries, new supplies of oil or competing fuels and development of more efficient energy-using appliances and plant do not lead adjustments in the short or medium term. The more immediate adjustments are damaging for the world economy as they operate through a recession which reduces energy and oil demand and, depending on its severity and OPEC's ability to resist pressures, brings oil prices down.
- (3) In a tight market situation, particularly when some significant importers find themselves cut off from their traditional sources of supply (like the Japanese refiners in 1970 and Eastern European and some developing countries in 1990), buyers tend to bid prices to very high levels. The lack of substitute for certain petroleum products, the pervasive and multifarious use of oil in all parts of modern economies, and the deeply ingrained view that oil is a strategic commodity, combine to explain this willingness to pay as high a price as necessary in an emergency. Because of sheer volume in international trade and heavy weight in the balance-of-payments of major importing countries, big price rises have serious macro-economic effects on the world economy.
- (4) In a slack market, the most prevailing state of affairs, there is always the threat of a price collapse. A rapid fall of prices and a long stagnation thereafter at a low level, will cause economic and political disruptions in the oil-exporting countries of the third world, strains in most energy industries around the world, and much disquiet among governments of those consuming countries concerned with strategic problems of import dependence, long-term *economic* security of supplies, or even consumption restraints for environmental purposes. (In some cases domestic taxation can play the same role as higher international prices, but the former is unpopular in some countries while the latter can be blamed by governments on the actions of outsiders.)

The political aspects of the 'oil problem' are therefore generally distinct from the economic features. A relationship exists, however, between oil revenues and political situations in some oil-exporting countries. Both sudden increases and

sudden collapses of oil income can be destabilizing. These sudden changes played a part in bringing about the Iranian revolution, civil unrest in Algeria and the unjustifiable Iraqi aggression against Kuwait. The political problems can only be eased in the long run through the progress of democracy, genuine economic development (as distinguished from mere income growth), the solution of the Arab-Israeli conflict and other regional disputes, and the building up of healthier relationships between the Western powers and the developing countries concerned - relationships founded on the mutual respect of sovereignty.

The economic problems essentially relate to a feature of the oil industry which Paul Frankel already identified some fifty years ago. In his words: the oil industry is not self-adjusting. In modern terms one would say that adjustments always take place, but in this case they are not always rapid and never smooth. In the short term the supply/demand equation is brought back into balance by the disruptive signals of very big price changes. Once excess capacity is used up, prices, because they fail to choke off demand by inducing *immediate* substitution, begin to affect income thus producing or aggravating a recession which in turn reduces oil demand.

In the long term, the rate and pattern of energy investments are the critical parameters. Investors over-react to the short-term price signals, and to the current state of demand. High oil prices encourage huge investments in high cost oil and substitutes, but depressed demand affects behaviour in the opposite way. Low oil prices are a deterrent to investments unless buoyant demand provides at the same time strong incentives. This is a common state of affairs in all industries. Energy is different, however, in important respects, first, because typical projects are very big, have long gestation periods once initiated, and usually suffer from very long delays in the pre-investment stage because they often involve complex negotiations between companies and governments and cumbersome planning procedures with local authorities and regulators.

The system is prone to be overloaded with surplus capacity over fairly long periods of time, and then finds itself short. Shortages of capacity (relative to demand) do not persist for a long time because of the violent price reactions mentioned before which affect income and bring energy/oil demand down. The prevalence of a state of excess supply is not always a symptom of comfort, as it sometimes simply reflects the grave ailment and long convalescence caused by a traumatic shock.

Of course, past investment behaviour, in that it determines current capacity levels, plays together with demand the important part in the setting of market prices. So the circle closes up: from prices and demand to investments which after a long lag replace or add to capacity, and then from capacity and current demand to prices and both future investments and demand.

But does all that amount to a significant problem?

Here, the answer relates to the costs borne by various parties when the world is subjected to an oil shock. There is a *prima facie* case for thinking that when a system is prone to price shocks and can only adjust to them in the short-medium run through economic recession, considerable economic costs are involved; and a case for thinking that sharp revenue fluctuations can cause political instability followed by serious economic damages.

So far we have only examined the 'energy problem' in terms of investment cycles, supply disruptions and prices. Recent concerns about the global environment add a complex dimension to the problem. The global environment is a public good for the world as a whole and measures for its improvement pose the classic issue of co-operative strategies. Individual action by a country would be futile in this context if others continue to pollute the atmosphere. The framework for co-operation in energy and the environment does not only involve a divide between consuming and producing countries (the former having probably a greater interest in reducing the demand for energy than the latter), but further and more numerous divides between virtually all countries of the world.

### 3 THE MARKET

There is certainly an energy problem. Undesirable states of affairs emerge from time to time, and they involve huge costs, now to consuming countries, now to producing countries, and on some occasions to both. So far the world has responded partly in a passive manner and partly in very active ways, accepting these costs (albeit with some protest), and incurring additional ones through inadequate or very expensive policies.

To recognize that a problem exists does not necessarily imply that its solution calls for formal co-operation between the parties involved. There may be other mechanisms which can adequately deal with the problem. We need not search long to identify a possible candidate. Many industrialized countries, and among them the USA, the UK and Germany with greater emphasis, affirm that the market provides such a mechanism. The extreme position is that the market dispenses with the need for a dialogue; the qualified view recently reiterated by the IEA is that a dialogue is only agreeable if it excludes the discussion of production and prices as these relate entirely to the market.

Nobody doubts that there is a market which is the locus of economic forces that determine prices. In fact, our view is that there has always been an international market in oil even when the vertically-integrated oil companies internalized a large proportion of crude oil transactions, and dominated the scene. But the simple observation that markets do exist need not imply any of the following:

- (1) The world petroleum market operates without any interference other than OPEC's attempts to regulate production;
- (2) The market is an insurance against shocks, and even when it fails to prevent their occurrence it subsequently removes their effects in a satisfactory manner;
- (3) However imperfect, the market yields better outcomes when its operations are left free from any type of interference than when policymakers intervene.

The first proposition is wrong. Several commercial entities seem to enjoy some power in important segments of the world petroleum market - for crude oil, in Brent and Dubai, for petroleum products in NW Europe for example. They can, but may not always wish to, exercise some leverage. This aspect may not be too serious however. The more interesting forms of intervention were indicated in the previous section. They relate to the USA which in times of crises, and apparently only then, intervenes discreetly by signalling a strong preference for either a price policy (1979) or a price level.

Some observers may also argue that the consuming countries' response to oil shocks in the past twenty years is in essence a set of interventions aimed at controlling demand, and is therefore analogous or symmetrical to OPEC's attempts to control supplies. In short, both sides are known to intervene in a market which, even otherwise, is not absolutely perfect.

The second proposition is falsified by the experience of the 1970s and 1980s, and in any case does not always stand the test of logical scrutiny. The market, by definition, is powerless when it comes to preventing oil shocks caused by political factors. More interestingly, it can be argued that the market cannot prevent shocks arising from an inadequate match of past investments with current demand levels. The market is strongly oriented towards the allocation of resources in the short run. It may perform this role very efficiently in the short time frame and still be unable four, five or many more years in advance, to provide the signals as is required for investment purposes, capacity needs and the long-term adjustment in demand behaviour. This is because time lags are very long in investments for energy supplies (and conservation); the set of futures markets is incomplete; capital markets are imperfect; the degree of risk aversion differs markedly between the relevant economic agents (companies and countries); and because there are externalities which the market cannot take into account and which happen to be particularly important in oil.

And nobody relies exclusively on markets for adjustments and the mitigation of the adverse effects of shocks. All governments have recourse to policy to deal with these effects at both the macro-economic and the sectorial level.

The third proposition is as difficult to prove as to refute. Blind faith in government interference has caused many conspicuous economic disasters. But to replace it by blind faith in the market can also be damaging, albeit perhaps in less conspicuous ways. As all governments know, the question is not whether policy has a role, but how, when and to which extent policies should be introduced. The challenge is to design and implement policies that improve market outcomes, and to argue that this can never be satisfactorily done is nothing more than a lazy refusal to accept the challenge.

The general conclusion, therefore, is that the existence of a market does not by itself contribute a case against the promotion of a dialogue between interested parties and does not rule out, *a priori*, the search for co-operative solutions with an open mind as to their merits and shortcomings.

The argument, as presented so far, has been made at a fairly general level. It may be useful to look more closely at the specifics of the world petroleum market in order to identify more precisely problems of performance and possible remedies.

The central problem as regards the pricing of oil is the existence of a very wide gap in the short and medium run between the cost floor and the ceiling set by substitutes. When there are excess supplies, competitive forces tend to drive

the price of a commodity down to the cost floor. In oil the floor is at the very low level of perhaps \$2.5/barrel. If prices were to fall to that level very little capacity would be shut down. Supplies are not immediately affected to a serious degree in this situation, but the first wells to be shut are likely to be in OECD countries (and if economic costing was to prevail, in the Soviet Union). The competitive adjustment to this situation is both clumsy and disruptive as it would operate through a reduction in investments and a tightening-up of the capacity constraints after a few years. On the demand side, low prices induce growth which may hasten the adjustment (this depends in part on the initial amount of excess capacity, the trigger of the price fall, in the system).

In a situation of excess demand, the price of oil is not subject to a cap placed by substitute because some petroleum products, such as gasoline and jet fuel, do not have readily available substitutes on the necessary scale. The cap on prices emerges at an unpredictable level, through, first, an income-led decline in oil demand and, usually later, a further reduction in crude oil demand caused by substitution at the heavier end of the barrel. If past experience is any guide a price cap seems to emerge at around \$40-45/barrel. Here again the adjustments are clumsy and disruptive.

Competitive forces are never allowed to push the price of oil down to the cost floor. On the way down, there is always *political resistance* not only from OPEC member countries but from every party with an energy industry to protect. Similarly price rises generate much *political heat* on their way up and this often interferes with economic behaviour. In normal situations the market has to find a price level, without much help from the two fundamental economic forces (costs and substitution), somewhere within the very wide and soft gap that separates the rigid floor and the hard cap.

Before 1973 (even then there were some spot transactions) market prices tended to fluctuate around \$2-4/barrel; between 1974 and 1978, around \$11-12/barrel; between 1981 and 1985, around \$27-30/barrel; and after 1986 (the Gulf crisis excluded) around \$16-19/barrel. The past twenty or thirty years have thus been divided by shocks into a number of discontinuous pricing episodes. Throughout each episode the market causes prices of spot and futures transactions to move from day to day in a fairly volatile fashion. Despite this volatility, prices tend to remain most of the time close to a level which characterizes the episode. Very large divergences are usually corrected, after a lag, by OPEC action or some change in market sentiment. When the divergence is caused by a political crisis (e.g. in 1973 and 1979) or a structural change in economic behaviour (e.g. in 1980) there is discontinuity and the emergence of a new episode characterized by a new price level.

There are therefore two types of price instability which need to be carefully distinguished: the volatility that obtains during pricing episodes and the change in price levels between episodes. Their causes are different; their effects are different; and were stabilization to be a policy objective, they would each call for a different approach.

One would have no problem with volatility if price movements reflected, from any given starting point, changes in fundamentals; that is current and expected consumption, production and inventory levels. But this is rarely the case. First, the information that reaches the oil market on all these variables is often of very poor quality partly because producing countries and oil companies (supported by their governments) are obsessed with commercial secrecy. Secondly, the three main crude oil markets (WTI, Brent and Dubai) are in essence regional rather than global. In each one, prices respond to changes in local rather than global conditions, changes that may be significant in mid-continent USA or for a small set of North Sea producers or European refiners but fairly minor for the world oil supply/demand balance at the time. But these price changes are transmitted to the whole world oil trade through the automatic mechanism of pricing formulas.

We would have no objections to this system, often justified by the principle that prices are determined at the margin, if we were convinced that the margin is a Brent or a WTI barrel. It is not. The margin is where production can be easily increased or decreased in response to world demand changes. Nobody other than OPEC, or more precisely some Gulf countries, has the leeway that defines the margin.

Oil price movements are now set by unrepresentative, narrow and poorly informed markets. This is the reason why volatility is disturbing. As we shall see later this particular problem can be remedied to a significant (although not a full) extent with relative ease.

The second type of instability - the structural shifts in prices from one episode to the next - usually causes more worries; and we suspect them to be behind the yearning for co-operative solutions. Some shocks, those related to investment behaviour, are avoidable. Shocks due to political causes, by definition, cannot be prevented by energy policy. They can be managed however through a judicious use of surplus capacity, inventory policies and oil-sharing programmes. The political issue of significance in this context is whether they should be managed through genuine co-operation or by a domineering superpower which finds it convenient in an emergency to dictate its views to all other parties as the USA did in 1990-1?

A crisis is a crisis. One may have to live through it as best as possible, but mercifully crises do not last very long. What matters more is the state of the world after the shock since some of its consequences usually obtain during much longer periods. The question, therefore, is which price of oil after a crisis? The market will always need a cue. The cue can only come from those who have either market or political power. Is it preferable to have the cue uttered by OPEC alone, or by the USA alone, or by the meeting of minds between consumers and producers in the framework of sensible co-operation?

Analysing the oil market brings us back inexorably to political questions.

#### 4 NATIONAL, REGIONAL AND BILATERAL APPROACHES

That there is an energy problem of sorts, and that the market cannot be fully relied upon to provide all the remedies is implicitly recognized by those countries and international organizations that are proposing energy strategies and regional plans. The most significant are the US National Energy Strategy, and the Energy Charter for Europe, also known as the Lubbers' plan. There is also much talk about the merits of bilateral relationships, particularly between the USA and Saudi Arabia, as effective means to solve problems. We propose to review and assess these three main approaches.

##### **The US National Energy Strategy**

Before the shocks of the 1970s what little there was of a US energy strategy revolved around the (unstated) goal of making available fuels in large quantities from secure domestic sources. There was protectionism, regulation and intervention (the Texas Railroad Commission, oil import quotas, cost-based price regulation for natural gas etc.); and also anti-trust policies to protect consumers from the mischief of big business.

By the late 1960s, however, the perception that domestic oil and gas reserves were being rapidly depleted, and that increasing reliance on imports would soon reach 'undesirable' levels, causing dangerous political dependence on the Middle East, began to take shape.

Soon after the 1973 shock, the first of a series of plans and strategies saw the light of day. The first was Project Independence, leading to the Energy Independence Act (President Ford); it was followed by Carter's National Energy Plan of 1977, part of which eventually became the National Energy Act. All these proposals and Acts involved direct government intervention.

The philosophy changed under President Reagan. The Republican administration believed in the merits of market forces as against intervention. There was deregulation in both oil and gas. The emphasis shifted away from curbing demand through conservation to increasing domestic supplies by removing price controls and alleviating the tax burden on producers. The administration also took the view that the Strategic Petroleum Reserve which was built up systematically would provide the best protection in the event of a new shock.

The National Energy Strategy was initiated with commendable timing (President Bush's directive to the US DOE in July 1989) before the Gulf war and a report was released in February 1991. The document reflects the same preoccupation and objectives as its many predecessors: security of supplies, protection of consumers' interests, environment. A market-oriented philosophy is emphasized in words, and consistently followed in a report remarkably devoid of hard policy proposals. Heavy reliance is placed on technological progress resulting from additional research and development by private industry; the opening-up for

exploration and development of oil-bearing areas hitherto kept closed; and on prospects for nuclear as opposed to coal and synfuels which played a prominent part in earlier energy plans and strategies.

The most generous assessment of the National Energy Strategy is that it describes developments in the next twenty years which will achieve with very little help from policy measures all the desired government objectives. The help is largely in the form of further deregulation, minor reduction in the fiscal burden, opening-up of federal land for oil and gas exploration as mentioned above, and improvement of the US educational system. It politely and verbally encourages outcomes and developments which it expects the market to produce anyway. Although it clearly defines the US energy problems, it leaves the reader with the impression that in the end there are no problems the government needs to worry about. The market takes care of everything as one goes along. To call the exercise a strategy is a considerable misnomer. A more apt characterization is a 'nudge and a wink' from a kind government to this hard-working, slightly overburdened, but efficient and always obliging friend, the market.

In our perspective, the National Energy Strategy is of no great significance for the problems faced by the world on the energy front. It only says that the USA will be much better off on the security, the efficiency and the environmental front than they are today. An act of faith rather than a rational contribution to the solution of a serious issue.

### **The Lubbers' Plan**

In June 1990 at the Dublin Summit of the European Council of Ministers the Dutch Prime Minister, Mr R. Lubbers, presented proposals for energy integration in an expanded Europe between the Atlantic and the far eastern end of Siberia. The central idea is to create an European Energy Community comprised of all of Western Europe (not only the EC-12), the Central and Eastern European countries including the Soviet Union. The immediate rationale lies in the complementarity in energy of the Soviet Union, which has considerable reserves of all the main fuels, and Western Europe which constitutes a huge market. The Lubbers' plan has been developed by the EC Commission into a draft European Energy Charter. The stated objectives (see EC document COM(91)36 final, 14 Feb 1991, p.9) are 'to improve security of supply on the most satisfactory basis and developing energy activities with due regard for the environment'. In short, security of energy supply is the main goal; and as this requires expansion of energy production through investments which may cause pollution and other harm, the main objective is qualified by the usual caveat about the environment.

To achieve these goals the Charter proposes action in six areas, there again the ordering of the list reveals priorities. The proposed fields of action are as follows:

- (1) Measures to facilitate *access to resources* by all the interested investors. In practice, this appears to mean: the Soviet Union should allow foreign (in this context European) investors in the oil and gas sector.
- (2) The removal of barriers and all forms of discrimination that hinder the *exploitation of resources*. The draft goes as far as stating that the signatories shall agree to avoid imposing discriminatory rules about 'the ownership of resources'. This point is an extension of (1).
- (3) Agreement on *rules on investments*, very specifically a guaranteed 'right to repatriate profits and to obtain or use the convertible currency needed'. This further point is also an extension of (1) and (2).
- (4) The promotion of *growth and diversification of trade* by removing barriers to trade 'with each other' in energy products and by encouraging the development of main international transmission grids, their opening up to users and their inter-connection. The explicit reference to intra-European trade barriers begs the question of trade between Europe and the rest of the world and raises fears about the emergence of a fortress Europe. These fears are not going to be assuaged by such soothing words as 'Europe must not isolate itself from the rest of the world' (op cit par.8, p.2).
- (5) The formulation and implementation of common *technical specifications and rules on safety*.
- (6) Exchanges and co-operation in *research, technological development and innovation*, with due respect to industrial and commercial property rights.

Specific agreements on eight issues will give body to some of these objectives. Interestingly seven relate partly or totally to supply (nuclear reactor safety, clean coal technologies, renewables, gas transmission via high pressure pipelines, power stations, oil transportation and refineries, technology transfers). Only one is concerned with the efficient use of energy and two of the proposed agreements refer to energy use (gas and oil).

The wider aims of the Charter are geo-political. Integration in energy is a means to provide support to the East European countries which have recently broken away from the Soviet compact. More significantly it may be construed as a foundation for the economic and political integration of a very large entity, a Greater Europe that includes Russia and its immense Asian empire. The ambition, perhaps, is that the building-up of an integrated energy market may play in the future the same role as the Coal and Steel Community of yesteryear. This initiative led to the establishment of the European Common Market and the European Community.

Cynics may attach less importance to these wider areas and just see in the Charter a thinly disguised attempt to annex for the benefit of Western Europe the immense natural resource of Asiatic Russia. The reserves after all are mostly in

Siberia, and out of the six stated objectives of the Charter the first three are about the development and exploitation of these reserves by foreign operators.

The charter implies that Western Europe will feel more secure if it becomes more dependent on the Soviet Union and less on the Middle East. Some oil companies may see better prospects for their investments in the former than in the latter; for instance, the president of ENI, Mr Cagliari, went as far as depicting as realistic a scenario in which the Soviet Union would be producing 18 mb/d of oil and an additional 50-100 billion cubic metres of gas in a decade or so. This can only be done with Western investments and technology and would make Europe virtually self-sufficient.

There is no doubt that political risks characterize the Middle East; but what about the risks facing investments in the Soviet Union? Security is better achieved by diversification than by a significant switch to a new, major source of supply. There is a serious inconsistency between the Charter's main objective (security of supply) and the main measure proposed (reliance on investments in the Soviet Union); and an inconsistency between what this measure is expected to and what it can realistically achieve.

### **Special Bilateral Relationship**

A third way, other than national or regional approaches, for handling the energy problem is the reliance on special bilateral relationships. The USA which has just produced an energy non-strategy, taken umbrage to the Lubbers' plan, and rejected the idea of a multilateral approach, is said to place great store on its privileged relationship with Saudi Arabia.

Before the Gulf war, US references to this relationship were concealed behind broader statements such as: 'we are talking all the time to most producing countries and to our IEA partners on a bilateral basis'. And Saudi Arabia, for good reasons, always found references that singled out its relationship with the USA to be offensive as they seemed to question the exercise of its sovereignty on oil markets.

After the Gulf war the USA has become more precise about it all. If reports in *Platt's Oilgram News* are to be trusted one would express some surprise at the tone of Energy Secretary Watkins' reference to the dialogue. He is alleged to have said that there would be 'a question of what you're trying to achieve that we don't already achieve very nicely by other means', which includes the US-Saudi 'special communication' (See Vol 69, No. 110, pp 1 and 5). The phrase 'achieve very nicely by other means' - which are defined as special bilateral relationships - is a trifle offensive to all those who stand outside them. They may not find much political consolation in being told that this benefits 'the world interest and the world need' (p.5).

The intellectual argument behind Watkins' statements was provided by Edward Morse in *Petroleum Intelligence Weekly*, 27 May 1991, pp.6-7. His idea is

that the USA and Saudi Arabia should work out a bilateral agreement that involves, in stages, the following:

- planning for strategic oil storage and use. The USA would purchase or lease oil from Saudi Arabia to build up its strategic stock from a current 580 million to 750 million barrels; and Saudi Arabia be allowed to create in the USA its own stockpile for its own commercial and strategic purposes. In a future crisis stock release policies would be co-ordinated by both parties.
- providing unfettered Saudi access to the oil downstream sector in the USA and reciprocally guaranteeing US firms access to Saudi Arabian oil on a long-term basis at market prices. This could beneficially involve an opening up of the Saudi upstream sector to foreign investment.

Morse thinks that this would benefit the world. 'The US *and other consuming countries* (our emphasis) can get an insurance policy against future disruptions'. Further he thinks that bilateral arrangements of this type (aimed at improving markets, ensuring energy security and guaranteeing investments and trade on a mutual, reciprocated non-discriminatory basis) could be multiplied and later form the core of a future multilateral arrangement.

There is an uncanny symmetry between the US ideas as suggested by Morse and the European ideas as expressed by Lubbers and the Commission. Both are concerned with their own energy security. Both seek (the European with just some faint disguise) privileged access to a major source of supply, Saudi Arabia for the USA and the Soviet Union for Europe. Both want to open the upstream sector of these partner countries to their investors. The USA goes further than Europe in one respect: it would like to import on its own territory Saudi oil reserves in the form of two stockpiles, one owned by the USA and the second by Saudi Arabia, while the Europeans are content with exploiting Soviet resources. Both tell us, without explaining how, that their bilateral schemes (for the Charter despite its apparently wide geographical coverage is in essence a blueprint for a bilateral relationship with the Soviet Union) are good for the rest of the world. The interesting difference, however, is that the USA deeply dislikes being excluded from the European scheme and is expressing its disapproval while Europe would not worry too much about the US-Saudi special relationship if it were allowed to pursue the Soviet affair.

The weakness of bilateral relationships as a solution to a world problem is that they are bilateral. At best, they may benefit the two parties involved but rarely provide gains to those left in the cold outside. The building up of strategic stocks in the USA is certainly good for them in times of emergency. They provide no relief to other consuming countries unless the US decision on their release is determined by a consideration of these countries' interests. The benefits only spread when there is multilateral understanding on the stocks release policy. Otherwise every country, including poor developing nations, needs to build up strategic stocks irrespective of whether the USA and Saudi Arabia have a special

deal. Relief can only occur after the actual date on which the USA decides to release stocks as this reduces US demand in a tight oil market and frees supplies for meeting demand from other parties. During the Gulf events, the only precedent we can consider, the USA announced its intention to release stocks five months after the onset of the crisis, that is just before the beginning of hostilities, and at a time when the world was awash with oil. Not much comfort for those who found themselves shut off in the first months of the crisis.

A critical bilateral relationship between a superpower and a developing country is politically embarrassing for the weaker partner. To cause embarrassment which involves risks of political destabilization is a very odd way of approaching a problem of international security. Saudi Arabia in the discreet and subtle manner which characterizes its diplomacy is expressing its concerns about the emphasis placed by the USA, and by so many commentators, on the special bilateral relationship, without any explicit statement. It is expressing it very simply by lending support to the concept of a multilateral dialogue.

We would also argue that the Watkins' concept, as explained by Morse, and the Lubbers' plan, as developed by the Community may not in the end be in the USA or Europe's interests.

The privileged relationship enshrined in these concepts is a political tie between the USA or Europe and particular regimes, not necessarily the nations which these regimes govern today. Nations usually live much longer than their governments; and the long-term stability of any bilateral arrangement depends on whether it fully takes into account national interests. This is the acid test to which all these plans and ideas must be subjected. We doubt whether, as formulated now, they would pass this test.

## 5 AN AGENDA FOR A FRUITFUL DIALOGUE

There is a need for a dialogue simply because there is an energy problem and because the variety of proposed approaches to its solution are not fully satisfactory. To say that there is a need for a dialogue does not necessarily imply that it should lead to a multilateral agreement between states. The notion of a dialogue is different from a multilateral agreement. One main difference being that the former is not binding while the latter is; another important difference is that a dialogue is nothing but an exercise in exploration which can lead to different types of discoveries or to none. A multilateral agreement may be found to be the best in an array of possible solutions; and it may not. As defined here, a dialogue can only be successful if undertaken with an open mind as regards the merits and drawbacks of all relevant approaches to the energy problem.

A first attempt at a dialogue will take place in Paris on 1st and 2nd July 1991, unless scuppered at the last minute by too many defections. For a variety of reasons the omens, unfortunately, are not very good. The most important difficulties are as follows:

- (1) The USA is not approaching the issue with an open mind. Without this major player the dialogue may not proceed as effectively as it should; and any multilateral agreement between oil producers and consumers that might arise from it does not have much meaning.
- (2) None of the other major players seems prepared to exercise pressure or leverage to persuade the USA that their isolation on this issue may be counterproductive. On the consuming countries' side an alliance between Europe and Japan would embarrass the USA. But Europe is divided into three groups at least: those who want a dialogue, those who believe that the market is the best available solution to all problems, and those who want to go the European way with the Lubbers' plan. And Japan has too many urgent issues on its agenda with the USA to want to add, unnecessarily perhaps, yet another one. On the producers' side, Saudi Arabia has potentially the greater leverage since it is being courted for a special bilateral relationship. If Saudi Arabia were able to say clearly that such relationships, important as they may be, cannot and will not be contemplated, if they are construed as an exclusive substitute to multilateral initiatives, the USA would be induced to revise its stance. But is it fair to ask Saudi Arabia to adopt a position which neither Europe nor Japan seems able to hold?
- (3) Not enough thought has gone so far into defining the elements of a dialogue: issues, interests of various parties, objectives and means. Much groundwork needs to be done for giving structure and substance to the idea of a dialogue; and it is not enough to state and emphasize its desirability without the more demanding intellectual effort required to clarify the concept.

We now find ourselves in the peculiar situation where the two countries promoting the dialogue have not worked out the concept in sufficient detail ahead of the Paris meeting; where OPEC wants a dialogue for the very cogent reason that it cannot by itself bring stability to oil markets, but it is precisely this perceived weakness which unbalances the basis of the consumers/producers relationships; and where most industrialized countries willing to participate will make no substantial contribution for fear of alienating the USA.

Because of these handicaps nobody seems to expect the July meeting in Paris to be a resounding success; but in the circumstances this is an advantage. The Paris meeting could kill the idea of a dialogue for many years to come if it is perceived to have been a failure. But because of low expectations, an indifferent or inconclusive meeting may not be too harshly judged as a disaster and leave the scope for a later resumption of the dialogue more or less intact. Sadly and paradoxically, low expectations are our best insurance against the premature death of a very fragile infant.

These considerations aside, we still need to answer the question: since a dialogue will soon, or may one day take place, *quid agenda?* A tentative answer is the only contribution that an Institute can make in this area since everything else involves power politics and requires action on the part of sovereign governments.

Our proposed agenda is to ask delegates to explore a limited number of propositions.

- (1) One aspect of the energy problem is the occurrence of political shocks which disrupt oil (and one day perhaps gas) supplies. These problems cannot be avoided by energy policy (their solution calls for political action of a different type) but it is possible to mitigate their effects. The best remedy to offset supply disruption in one part of the world is the existence of surplus capacity in other parts. The second best is the building up of strategic stocks in every country. Surplus capacity in exporting countries is preferable to stocks, as mentioned in a previous section, because oil lifted from an export terminal can go to any place where it may be needed while oil released from strategic stocks tends to stay in the country. Since the incidence of a political shock cannot be predicted in advance (it could happen in any producing country) one cannot put much reliance on excess capacity that is mainly located in one place. By the same token bilateral arrangements do not provide good protection since the producing country in the relationship may be itself subject to political risks. One needs therefore a safety net of idle capacity spread around the oil producing world and a complement, for additional safety, of strategic stocks distributed around the consuming countries. To carry either surplus capacity or stocks is expensive but the best remedy to a shock is the reliance on diversified portfolios of both. The item of discussion in a dialogue would relate to (a) the design of schemes for financing the holding of surplus capacity in a range of producing countries and strategic stocks in developing countries;

and (b) the establishment of rules governing the use of surplus capacity and stocks in an orderly manner during an emergency.

- (2) A second aspect of the energy problem relates to the investment cycle. In this area regular and formal exchange of information about investment plans and demand forecasts by national and international oil companies of significance cannot but benefit all concerned. We are not suggesting monopolistic conspiracies but an improvement of information flows. The dialogue could easily address the question of whether such an exchange of information is desirable, and how to organize it in simple and effective ways.
- (3) A third aspect is that day-to-day price movements in spot and futures markets may be divorced from changes in economic fundamentals. All parties seem to be agreed on the importance and the need to preserve the integrity of markets. We accept this view but wish to go much further in its support. Since markets are believed to be important then no effort should be spared to improve their performance and efficiency.

A dialogue can usefully explore ways of determining and directing these efforts. Good information is important for efficient market performance. In this context oil-producing countries could commit themselves to cease treating output data as state secrets and publish them regularly at short intervals; and the industrialized countries could commit themselves to impose on oil companies under their jurisdiction the release of detailed information on stocks, prices of market transactions (e.g. on Brent deals), and production ceasing to treat them as commercial secrets in need of special protection.

If markets are to be relied upon to provide correct allocative signals they must truly reflect the operation of the margin. As mentioned before neither Brent, nor WTI, nor Dubai can be correctly construed as markets that handle the incremental/decremental production of the world. The issue of establishing a representative and broad base market is a difficult one which requires much informed discussion between the main producing countries and between enlightened governments on both sides of the consuming/producing divide. The issue is complex because a market which correctly reflects the true supply margin is by definition a market that will be constantly dominated by a price maker. The difficulty is that nobody will want to speculate in such a market. But the problem is not necessarily insuperable and an informed dialogue can make interesting contributions for clarifying this issue.

- (4) A fourth and most important aspect is that the oil price level (as distinct from the volatility around a base level) is not subject in a straightforward way to economic determinants. To insist as the US government does, and with it most other parties, that the dialogue should avoid any reference to price does not make any sense. Price is the central issue, not because of

some distrust of the market but because economics has nothing to say about the oil price other than pointing to a dangerously low cost floor and a frighteningly high price-of-substitute ceiling. Price fluctuations are of the market, price *altitudes* are political variables. To pretend otherwise is not very helpful.

We do not see why the political signal to markets about the oil price *altitude* should come from the USA whispering in the ears of one or two decision makers in producing countries, and not from a wider forum where all major interests are represented. Of course it may be diplomatic to avoid the price issue in the first stages of the dialogue, but to turn the issue into a permanent taboo would be a fatal and unnecessary mistake.

- (5) Stabilization through greater integration of the oil industry is a recurring theme of debates in the past ten or fifteen years. Western oil companies have been campaigning with both coherence and determination to seek access to the upstream sectors of major OPEC countries and the Soviet Union. And some important producing countries, particularly Kuwait, Saudi Arabia and Venezuela, are seeking access in a similar way to the downstream sector in industrialized countries. The dialogue may undertake the task of thrashing out this issue once for all. If both sides of the argument are not made explicit, and the different motivations of the parties involved not bared to the bone in a frank exchange of views, disturbing suspicions will continue to linger on. The consuming countries seem to fear downstream investments by producing countries which they construe sometimes as a threat to their energy independence. And some producing countries suspect, perhaps with good reasons, that all the initiatives reviewed in this paper, from the Lubbers' plan to the proposed Paris meeting, are only designed to open a breach in their defences through which foreign investors will enter and establish a strong position in their countries. The sensible and robust response to these suspicions is to say: let us bring it in the open and talk it over until everything is clarified. After all, this is what a dialogue is all about.
- (6) As we happen to be in 1991 it is impossible to mention the term 'energy' without associating it immediately with the word 'environment'. We strongly believe that environmental concerns are of great significance; nevertheless they should not be included as a main item in the first agenda of a producers/consumers dialogue. To bring the environment into the picture in the first stage of this particular game will divert attention away from its main objectives. To introduce the environment on the agenda of the first meeting will ensure its failure. The first issues to be considered are supply security, investment, market performance, prices and industrial integration. This is an awesome list. Please leave the environment for later.

## 6 CONCLUSION

We have argued that there is an energy problem, or rather a set of issues that cause concern. The market can and does perform useful functions but provides no panacea. The market cannot prevent political shocks. It is too myopic to cope with an investment problem largely due to long gestation lags. Other approaches to the world energy problem often leave something to be desired. The national energy strategy of the major world player, the USA, is no strategy at all. Regional plans such as the Lubbers' proposals and special relationships, such as the US-Saudi link are nothing but open or disguised bilateral approaches. Because they seek supply security, they are fundamentally flawed; security is in multilateral diversification, not bilateral dependence. We have come in strong support of a dialogue, but remain at this stage non-committal on the question of multilateral agreements. The argument being that one main purpose of an open minded dialogue is precisely to assess the need and relevance of such agreements. We have finally proposed an agenda for a dialogue but remain profoundly sceptical about the final outcome of meetings until the USA changes its attitude.

The obstacle to a very simple but useful exercise, free talk around an agreed agenda, is US opposition sadly supported openly by the UK and in less obvious ways by Germany and some other countries. The US case is inconsistent. It says on the one hand that there is no serious problem, and on the other hand that problems must be solved in the framework of bilateral discussions. A momentum for a dialogue can only be induced by political action. Saudi Arabia needs to tell the USA that the bilateral relationships which the Kingdom favours for a wide range of economic, commercial and political objectives complement a multilateral approach that serves *other* objectives. Europe and Japan need to tell the USA that they are prepared to start talking in their absence, rather than appear to seek on all these issues Washington's blessings. However neither is willing to go that far. The energy problem has become entangled with that of the US political hegemony. Change Washington's mind and everything else will change.

As there are no good prospects for such a radical change of mind in the immediate future the question is whether it would be preferable to stop the clock now or begin the process with those who are willing to participate in the first meeting?

We are inclined to advocate that talks should begin. It may take a long time before the USA becomes convinced of the merits of a dialogue but this long waiting period can be profitably used studying in some depth the five or six items central to the agenda. The absence of the USA is a delaying factor not a fundamental impediment to the performance of this preliminary task.

Should the studies produce interesting solutions for the problems addressed and a compelling case for a dialogue leading to multilateral agreements, they would certainly change the mind set that opposes these approaches. The USA may rally at the end but much work has to be undertaken meanwhile. The Paris

meeting could be seen as a useful step if it produced an agenda for further work and generated a will to persevere. In the end, the cold light of reason may prevail against objections to the dialogue which owe more to ideology and the delusion of hegemonic power than to a balanced assessment of energy realities.

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