NSC Meeting

Iran-Iraq Energy Crisis

20 March 1984

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NSC Meeting on Iran-Iraq

20 March 1984

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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D.C. 20505

NIC #01787-84
19 March 1984

National Intelligence Council

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

FROM: [redacted]
NIO for Economics

25X1

SUBJECT: NSC Meeting on Iran-Iraq Energy Issues

1. The purpose of the NSC meeting is to establish some basic guidelines on which to base US foreign policy and economic actions in the event of a Persian Gulf supply interruption. The main issues for decision concern:

- o How should the US approach triggering the IEP sharing system in the event of a severe disruption?
- o To what degree should we seek consultation or coordination with our Allies on stock draws?
- o Should the US support coordinated international action to influence this market?

On each issue the options range from little or no US Government action (letting the market do the job) to various forms of joint action and coordination with other nations.

2. In our opinion, the issues on which the NSC is asked to focus basically address how best to minimize the impact of a given disruption on the world oil market. The Administration's main objective is to avoid a recurrence of the enormous price increases that occurred in 1979 in response to a very small world oil shortage. Although this is certainly an important objective, even more important are two types of policy action which are only briefly mentioned in the attached papers. These are:

- o What the US can do to prevent a supply disruption in the first place; and
- o What actions the US can take to minimize the size of any shortfall and its duration.

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3. The NSC study does not systematically review US diplomatic, economic, and military initiatives aimed at preventing an Iraqi escalation of the war which would threaten Iranian oil supplies, or an Iranian response which could threaten Gulf oil supplies. Up to now, both the Iraqis and the Iranians have been cautious in their actions, if not in their statements. Iraq will probably attack Iranian oil exports if its military situation looks desperate. But so far it is not, and US support for any Iraqi oil export pipelines, as well as continued large-scale Saudi assistance to Iraq, may prevent the worst from happening. These questions are being addressed in the CCPG, but we have not seen any paper.

4. Just as important is US deployment of military forces in the area, both to dissuade Iranian attacks and to deal with them if they occur. Working with the Saudis and Kuwaitis to increase oil industry security and to protect and rebuild facilities if an attack occurs obviously are also of critical importance, and little is said about the subject. DoD is examining these questions, but we are not aware that any interagency process is under way.

5. From an intelligence point of view, you may wish to make the following points:

- Although Southern Gulf oil facilities are highly vulnerable to attack, the chances are small that the Iranians would succeed in damaging them so severely as to cause an extended reduction in Saudi and Kuwaiti exports once the smoke had cleared. Most of the critical facilities would have to be largely destroyed to cause a big oil supply shortfall.

- Oil tankers in the Persian Gulf are highly vulnerable, however, to all kinds of attacks. Reopening the Straits would not make the Gulf safe for tankers. A large US naval presence might be required to do the job.

- If there were major attacks ~~against oil targets~~ on oil targets or disruption due to alarm + worst case speculation in the Southern Gulf, a great deal of uncertainty would prevail about the extent of the damage and its market impact. Initially oil prices would probably shoot up rapidly. The US Government could help calm the market by disseminating more accurate information. ~~The Intelligence Community can help in this regard~~.

- Since we believe that ~~the great majority~~ most of possible disruptions would have a relatively small and short-lived impact on world oil supplies, it makes sense to focus policy reactions on calming the market and releasing stocks, rather than on triggering major coordinated policy moves, such as under the IEA. The IEA should be activated only if the disruption is known to be large and likely to continue for at least several months.

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NATIONAL SECURITY COUNCIL
WASHINGTON, D.C. 20506

March 16, 1984

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MEMORANDUM FOR

MR. DONALD P. GREGG
Assistant to the Vice President
for National SEcurity Affairs
Office of the Vice President

MR. CHARLES HILL
Executive Secretary
Department of State

MR. CHRISTOPHER HICKS
Executive Secretary
Department of the Treasury

COLONEL JOHN STANFORD
Executive Secretary
Department of Defense

MR. BARRY ALLBRIGHT
Director, Executive
Secretariat
Department of the Interior

MRS. HELEN ROBBINS
Executive Assistant to the
Secretary
Department of Commerce

MR. WILLIAM VITALE
Executive Secretary
Department of Energy

MR. ALTON KEEL
Associate Director for
National Security and
International Affairs
Office of Management and Budget

MR. THOMAS B. CORMACK
Executive Secretary
Central Intelligence Agency

MR. WILLIAM NISKANEN
Member
President's Council of
Economic Advisors

AMBASSADOR HARVEY FELDMAN
Washington Representative for
U.S. Ambassador to the United
Nations

BRIG. GENERAL GEORGE A. JOULWAN
Executive Assistant to the
Chairman
Joint Chiefs of Staff

SUBJECT: NSC Meeting on Iran-Iraq Energy Issues (S)

A National Security Council meeting has been scheduled for 2-3:00 p.m., Tuesday, March 20, 1984 in Room 208, Old Executive Office Building to discuss international energy issues and policy options arising out of the Iran-Iraq war. Attached are an agenda (Tab A) and background papers prepared by the Department of State (Tab B). (S)

Robert M. Kimmitt
Executive Secretary

Attachment
Tab A Agenda
Tab B Background Papers

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TAB A

IRAN-IRAQ ENERGY ISSUES (S)

National Security Council Meeting

Tuesday, March 20, 1984

2-3:00 p.m.

Room 208, OEOB

AGENDA

Introduction (5 minutes)	Robert C. McFarlane
Overview of Oil Market Situation and Prospects (5 minutes)	Donald P. Hodel
International Energy Issues and Policies (10 minutes)	Richard Fairbanks
Discussion (35 minutes).	Principals
Conclusion (5 minutes)	Robert C. McFarlane

TAB B

S/S 8407454

United States Department of State

Washington, D.C. 20520

March 12, 1984

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MEMORANDUM

TO: The National Security Council

FROM: Allen Wallis, Chairman
International Energy Security Group (IESG)

SUBJECT: Energy Emergency Preparedness -- International Energy Policy Issues Requiring Decision

The IESG has completed the first phase of its examination of policies of an international character that will enable us to deal effectively with an interruption of oil supplies from the Persian Gulf. Several issues for decision are set forth in this memorandum; others, dealing with the macroeconomic impact of an interruption, will be presented separately. The DOE-chaired Energy Response Group will submit to the Cabinet a separate set of options dealing with domestic aspects of preparing for an emergency.

NSDD-87 establishes that US policy in a disruption is to rely on the market, supplemented by withdrawal from the Strategic Petroleum Reserve (SPD). The US is committed in case of an energy emergency to consulting with its allies both bilaterally and in the International Energy Agency (IEA)* and to fulfilling its obligations under the International Energy Plan (IEP).

*The IEA is made up of the 21 leading industrial countries (all of the Western European countries except France and Finland, as well as Canada, US, Japan, Australia and New Zealand). Collectively the members account for about 70% of free world consumption. It was founded after the 1973 oil disruption, and the agreement includes a sharing plan which can be triggered if oil supplies to an individual member or to the IEA as a whole drop by 7% or more. Under the plan if triggered, each member country has agreed to limit its imports of oil. The US is committed to fulfilling its obligations under the plan, and to participation in its implementation if triggered. An information paper describing more fully the plan and the trigger is at Tab A.

Because of the threat of major price and economic impacts we believe the NSC should address the international aspects of the policies set forth in NSDD-87. Descriptions of the options and the considerations involved are set forth in papers on each issue. This memorandum will briefly describe the current energy situation, the potential consequences of a disruption, and the issues for decision.

A. The Current Energy Situation

- The international oil market today remains soft. Free world crude production in 1984 will likely range between 43 and 46 million barrels per day, of which Persian Gulf supplies would normally be about 30%; 20-22% of free world supply will transit the Strait of Hormuz.

	NET IMPORTS as % of Consumption	IMPORTS Through Strait of Hormuz	STOCKS (Million Barrels)	
			Commercial	Strategic
US	31-34%	2-4%	1055	387
OECD Europe	65-68%	18-22%	1000	145
Japan	100%	68-69%	339	79

- Japanese and European stocks are lower than ours measured in days of imports, but comparable to ours if measured in days of consumption. The figures for commercial stocks are overstated since they include amounts required to operate the refining and distribution system, and those amounts (40-60% of commercial stocks) are not available for use. There is currently surplus oil producing capacity of some 9-12 million barrels per day (MMBD) in the free world, 3 to 3.5 MMBD of it located outside the Persian Gulf area. Some 58% of the 7.7 MMBD currently exported through the Strait of Hormuz could be replaced through full utilization of existing alternative facilities.

B. Potential for Disruption

- The conflict between Iran and Iraq presents the possibility of interruptions in supply. An escalation of the conflict could result in attacks on the major Iranian export terminal, Kharg Island. Iraqi success in preventing Iranian oil exports could lead to Iranian retaliation against other

Gulf exporters or international shipping, and as a last resort, to attempts to close the Strait of Hormuz. An effort to close the Strait is unlikely, and the US has pledged to keep it open. More likely (though not yet probable) are attacks against other facilities or international shipping. The US, in cooperation with other Western countries, would assist Gulf countries in protecting their facilities and international shipping, if requested. There is a risk of terrorism, subversion, sabotage or other attacks against oil facilities in the Gulf, which, if successful, could disrupt supply.

C. Economic Effects of Disruption

- Two previous oil disruptions (1973-74 and 1978-79), during periods when the US had price and allocation controls, led to sharp price increases and contributed to inflation and recession.

In 1973, loss of 6% of world supply quadrupled oil prices (from $2.86/bbl to $10.84/bbl); inflation then rose from 6.4% to 10%, and unemployment rose from 3.4% to 8.5%. In 1978-79 the disruption caused by the Iranian revolution resulted in a loss of 1-2 MMBD, most of which was offset by other production. The market reacted to concerns about future supply in a period of expanding demand with low stocks, and spot prices increased from $13.34/bbl to $38/bbl. The 1980-81 disruption of Iraqi crude exports caused a small, temporary price increase. Spot prices rose to $40/bbl and official prices from $32 to $34/bbl, from which they have since retreated to $29/bbl.

- An interagency Data Base Group has modeled five "scenario" disruptions that show that while the risk is low, a major sustained disruption could cause prices to rise sharply and result in substantial GNP losses. Even a smaller disruption could lead to sharp price increases because of market perceptions about the severity, duration and likely consequences. Government actions will influence these perceptions. These projections are based on defined circumstances and periods, and do not reflect the uncertainty likely in a disruption.

Case	Net Disruption (MMBD)	Duration (Months)	Average Crude Oil/bbl Price	US GNP Loss % Points
1	0	6	30-40	0.0-0.8
2	3	6	35-75	0.6-2.5
3	3	12	35-75	0.8-2.9
4	5	6	50-95	1.3-3.2
5	8	6	70-125	2.3--4.1

-The impacts estimated above are based on the assumption that NO actions are taken to ameliorate the impacts of a disruption. In particular, it is assumed that the SPR is not used, and that the IEP is not triggered (although a disruption of 5 MMBD might and one of 8 MMBD would exceed threshold levels for a general trigger).

-Data Base Group projections indicate that in a disruption causing a net loss of 3 million barrels/day prompt release of the SPR would keep prices in the range of $30-45/bbl, and that if foreign stocks also are used, prices would be held in the range of $30-40/bbl. In larger disruptions, similar beneficial price effects would be expected if stocks were released.

D. Issues for Decision

- Two sets of issues are within the framework of our present policy: whether and to what extent we should consult with our allies and others before a crisis, and what actions should we take during the first weeks of a crisis? Because any pre-crisis consultations turn on our policy for dealing with a crisis, we discuss first the options for a crisis. Of course, actions under our international energy policy will affect our diplomatic/military and domestic energy policy, and vice versa.

1. During a Crisis

There are three interrelated decisions that will effectively govern how we approach our IEA obligations during a crisis:

- how should the US approach triggering the IEP-sharing system in the event of a severe disruption? (TAB B)

- to what degree should we seek consultation or coordination with our allies on stock draws? (TAB C)

- should the US support coordinated international action to influence the spot market? (TAB D)

The IEP can be triggered only if one or more members suffer a loss of at least 7% in supply. In less severe ("subtrigger") disruptions, the US has agreed to consult with its IEA allies to determine what, if any, responses are needed. In the early stages of a crisis, the extent of a disruption is likely to be unclear. Even in a subtrigger disruption, the issues of stock draw and spot market actions will be raised, and some countries may raise the trigger. The IESG has not agreed on subtrigger actions.

Under NSDD-87, US policy is to rely on the market and to consult and cooperate with our IEA allies. Triggering the IEP system would interfere with market functioning, but some countries might press it, either for their perceived advantage or as leverage to obtain other actions. Drawing stocks would be consistent with both market functioning and cooperating within the IEA. It is our best weapon to limit economic damage from a supply disruption, and to fend off pressures toward market interference. Actions to influence the spot market are less clear, with some arguing the US intent would be only to provide information, and others arguing such actions are contrary to our market oriented policy.

- IEP Trigger - (TAB B)

The IESG generally agrees that activation of the IEA sharing system should be avoided, especially early in a disruption. Under the Agreement, however, if the Executive Secretariat of the IEA makes a finding triggering the system, it would be difficult for us to block under the voting system. At the same time, most IESG members believe that activation could be delayed if the US offered such alternatives as stock draws and perhaps agreed to spot market actions.

- Stock Use - (TAB C)

US policy as recently stated by Secretary Hodel is that early use of the SPR ordinarily is the most effective action we can take to reduce the economic impact of a disruption. Because our allies' stocks are smaller, they might decide to hold their stocks while the US drew down its SPR. The FRG, for example, has formally stated a policy of using its stocks only as a last resort. Congressional and public concern about unilateral stock draw then would become very intense. In light of this concern, the IESG agreed that US policy should support coordinated international stock draws early in a disruption. Any coordinated stock draw must take account of the circumstances should the IEP be triggered and the potential that the US would then earn the right to supplies from other countries.

- Spot-Market -- (TAB D)

The IESG is divided on the issue of actions to influence the spot market. IEA has in the past attempted to influence companies to restrain "abnormal" spot market purchasing in order to dampen price effects of a disruption. There are no convincing data to demonstrate the effect of jawboning. There is concern that jawboning can be counterproductive, would be seen as the first step toward other government intervention, and that it is not in accordance with the Administration's market-oriented philosophy. Some believe that the apparent effect of jawboning is related to the levels of available stocks (particularly commercial stocks) and market perceptions of future price paths, supply and economic activity. Others strongly believe that the option to approach companies about particular purchases should be retained, and that such efforts by other countries is one means to ensure that the Europeans and Japanese, despite the low level of their stocks, help dampen price spikes and market hysteria. The Europeans and Japanese would likely expect US participation in any IEA efforts to influence the spot market. Other IEA countries may also be expected to apply demand restraint measures prescribed under the IEP.

2. Pre-Crisis Actions

a. Consultations with Allies on Policy -- (TAB E)

Once decisions on our policy toward triggering the IEA system, drawing on stocks and attempts to influence the spot market have been reached it may be useful to consult other countries bilaterally and in the IEA to describe our policy and preparedness. Although this issue was not discussed in depth in the IESG, most agencies agree on the advisability of advance consultation on crisis management. The Department of State would undertake those consultations working with appropriate agencies, unless a decision is made to the contrary.

b. Urging Stock Build - (TAB F)

Beyond the issue of actions to take during a supply disruption, analysis indicates that stock draws are the simplest mechanism for reducing price impacts of a disruption. In light of concern that other countries are not sharing the burden of preparing to meet disruptions, we considered urging other countries to build their stocks. The US has raised this issue repeatedly in the IEA. The IESG believes that further efforts would be appropriate. Unless a decision is made to the contrary, the US delegation will raise this issue during IEA meetings and bilaterally and develop a strategy for further pursuit of the issue, including the possibility of redefining stocks to take into account the problem of operating inventory.

3. Information Papers (Tabs A - J)

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A

THE IEA ALLOCATION SYSTEM (INFORMATION)

1. Trigger Mechanism

The emergency oil sharing mechanism of the IEA was designed to assure an equitable sharing of the burden of any serious oil supply interruption among its member countries. Activation of the system is premised on close coordination and the development of a consensus that use of the system is truly necessary. Voting procedures are provided in the event of disagreement, although it is unlikely that those would be used. The IEA oil sharing system can be activated under two types of circumstances: the general trigger would be pulled in the event of an IEA wide loss of oil; the selective trigger for a serious loss to any one country.

-- General Trigger: The general trigger would activate the sharing system whenever IEA countries as a whole have sustained or "can reasonably be expected to sustain" a reduction in oil supplies of at least seven percent of the average daily rate of IEA base period final consumption of petroleum. (The base period is the preceding 4 quarters for which IEA statistics have been calculated.)

-- Selective Trigger: The system can be activated if any individual IEA member sustained or could reasonably be expected to sustain a shortfall of at least seven percent over base period final consumption.

While any IEA member can set in motion the process of making the determination that a trigger situation has occurred, it is expected that the IEA Secretariat would issue a recommendation in the first instance.

-- Voting Arrangements for activation/blocking triggers: When the Secretariat has made a finding that a trigger situation has occurred, it reports to the "Management Committee" which is composed of all IEA members. The Management Committee reports to the Governing Board within 48 hours. The Governing Board has a further 48 hours to meet and review the Management Committee's work. The Secretariat finding that a trigger situation has occurred will in itself cause activation of the system unless the Governing Board by a special majority decides not to activate the system.

Such a decision by the Governing Board to block activation would be difficult to reach. A "special majority" is needed to block a Secretariat finding. This would mean that 15 of the twenty countries voting (Norway as a non-participant

in the IEA plan does not vote) would have to oppose activation and 60% of the combined voting weights would have to be cast in opposition. To satisfy the latter condition, the U.S. would need to be joined for example by Japan, Germany, the UK and Canada in opposition. As can be seen, activation of the system was designed to be virtually automatic after a positive Secretariat finding that the shortfall conditions had been met.

Any member state can request a finding that a trigger situation has occurred. However, in the absence of a positive Secretariat finding, the voting system is skewed to make activation very difficult.

2. Calculation for Allocation:

After the IEA trigger has been pulled, IEA members are committed to consuming a percentage less than their normal consumption minus their obligation (if any) to drawdown strategic reserves. In any emergency in which oil supplies to the IEA are cut by seven percent, reduction in demand by each member should be seven percent. In an emergency in which supplies are cut by 12 percent or more, members are obligated to reduce consumption by 10%.

The method of computation of the actual quantities is given below.

The right of an IEA member to oil supplies pursuant to the Agreement (called the "supply right") is calculated as a percentage of Base Period Final Consumption (BPFC) less the Emergency Reserve Drawdown Obligation (ERDO). The BPFC is an IEA calculated figure for the four quarters preceding the last full quarter. (The provision allows the statisticians time to compile data.) Once the IEA trigger is pulled the same BPFC data are used for all calculations. The BPFC is not updated during a disruption. The ERDO is an IEA member's percentage of total IEA emergency reserve commitments multiplied by the amount by which total IEA supplies are less than the amount IEA members would be permitted to consume after a straight demand restraint calculation. (If IEA consumption were 100 units before a 7% disruption, then they would be 93 units after the demand restraint calculation but if IEA supplies available actually totalled less than 93, the IEA secretariat would apportion an emergency reserve drawdown obligation or an ERDO.)

In sum, the system is designed to apportion the shortfalls of a disruption in a fashion proportionate to size, consumption and imports of oil. The formula in a less severe interruption is weighted more heavily towards consumption; in a more severe disruption the weight on imports increases. (The shortfall is not "equally" apportioned as some might assume.)

IV. Impacts of the International Energy Program

This Appendix discusses the Emergency Sharing System of the International Energy Agency's (IEA) International Energy Program (IEP). The first section addresses the potential of triggering IEP sharing under each of the supply disruption cases previously specified. The second section assesses the supply posture of the United States and other IEA nations under IEP sharing. There are assumed to be no policy interventions (such as SPR drawdown) or abnormal stock movements in any case.

Trigger Calculations

Activation of IEP sharing encompasses a review of both quantitative (e.g., loss of projected supplies) and qualitative factors (e.g., weather, declining demand). This discussion addresses only the technical trigger calculation that compares disrupted supplies with the levels of oil consumption experienced during a previous 12 month period (called the base period). IEP sharing would not, in fact, be activated until the Secretariat makes a finding that the group or an individual IEA member sustains or is reasonably expected to sustain a reduction in oil supplies of at least seven percent of their base period consumption. The finding is then reviewed by the Governing Board of the IEA. The Governing Board could vote by "special majority" to override; or, if the Secretariat declined to make the trigger finding, the Governing Board could activate IEP sharing by a weighted "majority" vote. The "general trigger" of the IEP could be pulled if remaining supply levels for the IEA as a whole fall seven percent or more below the consumption levels experienced during the base period due to an oil supply disruption. However, the "selective trigger" of the IEP could be pulled if any one or more members' supplies are reduced by this amount.

In disruption Cases 1, 2, and 3, the net loss of free world oil supplies is assumed to range from 0 to 3 million barrels per day (MMBD). Until market forces allocate the available oil, nations that are heavily dependent on oil from the disrupted sources could experience temporary shortages. Although unlikely, several IEA nations that import significant amounts of the disrupted oil could invoke the "selective trigger." Based upon OECD trade data for the first three quarters of 1983, Persian Gulf import dependencies suggest the following candidate countries: Australia, Belgium, Japan, West Germany, Greece, Italy, the Netherlands, Portugal, Spain, and Turkey. The disruptions of 3 MMBD or less are not of sufficient magnitude to cause the "general trigger" to be pulled because they amount to less than 7 percent of total IEA base period final consumption (BPFC).

The oil supply loss in the 2nd quarter of 1984 resulting from a Case 4 disruption would probably be of sufficient magnitude to pull the "general trigger" of the IEP. The net loss of 5 MMBD of available world oil supplies is estimated to result in supply losses in IEA member nations of about 0.2 MMBD in excess of the required 7 percent of their BPFC. Hence, the "general trigger"

could be pulled. However, this is a borderline calculation and slight changes in the data could result in the trigger not being pulled. The United States' supply right under IEP sharing would be about 14.3 MMBD. This level of supply would be 1.7 MMBD less than the pre-disruption available supplies in the U.S.

The net loss of 8.0 MMBD of available world oil supplies assumed in a Case 5 disruption would result in supply losses in IEA member nations of about 0.6 MMBD in excess of 12 percent of their BPFC. Hence, the "general trigger" could be pulled at the 12 percent level, which requires a 10 percent level of demand restraint. The United States' supply right under IEP sharing would be about 13.5 MMBD, which would be 2.4 MMBD less than pre-disruption available supplies.

It should be noted that these trigger calculations were made based upon the best available historical data and upon the Energy Information Administration's quarterly oil forecast that appears in the February 1983 Short-Term Energy Outlook. Although there is no doubt that the 12 percent trigger threshold is reached in a Case 5 disruption, the pulling of the trigger in a Case 4 disruption is quite borderline. Because the IEA would make the trigger calculation on the basis of their own data and forecasts, it is impossible to predict whether or not they would reach the 7 percent trigger threshold in the Case 4 disruption.

Supply Posture of IEA Nations Under Emergency Sharing

Tables 17 and 18 present estimates of allocation rights and obligations for IEA nations under disruption Cases 4 and 5. It is assumed that the "general trigger" of the IEP has been pulled. By definition, a nation incurs an allocation right if its available supplies (the sum of indigenous production and net imports) are less than the supply right determined under the IEP sharing formula. Conversely, an allocation obligation will be incurred if available supplies are greater than the calculated supply right.

Table 17 presents allocation right/allocation obligation estimates assuming that no reallocation of available world oil supplies has taken place due to market forces. In other words, the only imports that a nation loses are those imports from disrupted sources. These results could only occur if world oil prices failed to rise and reduce demand during a disruption. Rights and obligations are derived by comparing these disrupted levels of imports with the import ceilings implied by the IEP supply right calculations. Under this "no reallocation" assumption, the United States would incur an allocation obligation of approximately 1.5 MMBD in a Case 4 disruption and 2.1 MMBD in Case 5.

Table 18 presents allocation right/allocation obligation estimates assuming that market forces have fully reallocated supplies; that is, sufficient time has elapsed such that world oil prices have increased and available oil supplies have been reallocated to reflect those market forces. Rights and

obligations are derived by comparing estimates of net imports based on a market solution to estimates of imports based on the IEP sharing formula. The estimates indicate that the United States would incur an allocation right of approximately 0.1 MMBD in disruption Case 4 and 0.4 MMBD in Case 5 once the market had fully reallocated supplies.

It is perceived that the allocation right/allocation obligation estimates presented on Tables 17 and 18 represent a range of extremes. Triggering of IEP sharing would probably dampen market pressures due to non-price demand restraint measures that would be adopted by other IEA countries. Thus disruption impacts presented in Section III would likely be lessened by triggering of the IEP. Table 17 represents a situation that would be very unlikely except in the very earliest stages of a disruption, before market prices rise and supplies are rerouted from their original destinations. As market forces bring about a reallocation of shipments, the situation would gradually evolve toward the equilibrium depicted in Table 18.

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ISSUE

How should the U.S. approach triggering the IEA sharing system in the event of severe interruption?

Current Policy

The U.S. policy emphasizes primary reliance on the domestic and international marketplace both before and, to the extent possible, during an energy emergency. It seeks to improve the functioning of the marketplace before an emergency so that it will operate with maximum efficiency once an emergency occurs. (NSDD-87, p.1.) The primary mechanism to protect against the worst effects of such emergencies is maintenance of stockpiles, including the SPR.

The U.S. has reaffirmed its commitment to meet its obligations under the International Energy Program (IEP) and is prepared to consult and to cooperate with its IEA partners in the event of a disruption in order to reduce panic, to minimize economic dislocations, and to ensure that individual countries do not suffer unacceptable harm as a result of the shortfall in oil supplies. The U.S. is prepared to consult and cooperate with IEA partners toward these ends, especially to foster market pricing of energy supplies and to increase stock levels, and to exchange information on national use of stocks (NSDD-87, pp. 9-10).

Background

The emergency oil sharing mechanism of the IEA is designed to assure an equitable sharing of the burden of any serious oil supply interruption among its member countries. Activation of the system is premised on close coordination and the development of a consensus that use of the system is mutually beneficial. Voting procedures are provided in the event of disagreement, although it is unlikely that those would be used. The IEA oil sharing system can be activated under two types of circumstances:

-- General Trigger: The general trigger would activate the sharing system whenever IEA countries as a whole have sustained or "can reasonably be expected to sustain" a reduction in oil supplies of at least seven percent of the average daily rate of IEA base period final consumption of petroleum. (The base period is the preceding 4 quarters for which IEA statistics have been calculated.)

-- Selective Trigger: The system can be activated if any individual IEA member sustained or could reasonably be expected to sustain a shortfall of a least seven percent over base period final consumption.

1. Selective Trigger Situation

Analysis - The IEA Secretariat has expressed the view that activation of the sharing system would be inappropriate either in a crisis of short duration or when the direct effects of a disruption are limited to one or two countries because of the dislocations in normal commercial practices that would follow triggering of the system. In this light, alternative supply arrangements or cargo diversions by the U.S. alone or by the IEA as a whole could be considered. Because price is a critical issue for the smaller IEA countries in particular, and because a disproportionate supply shortfall can persist only if the country is failing to pay world market prices, the first priority may be to try to persuade these countries to abandon price control policies and purchase on the open market. Such attempts however, are likely to be met by requests for international financial assistance.

Several smaller IEA countries are likely to be of significant importance to us because of the presence of U.S. base facilities and for their strategic importance in NATO. Portugal, Turkey, Greece and perhaps Spain fall into this category. If it is U.S. policy to assist these countries in obtaining oil supplies in the event of a serious disruption, we will need to decide whether to do so through the IEA allocation (i.e. use the selective trigger device) or to do so outside the IEA through bilateral or multilateral efforts directly with international oil companies. Concerted international effort to assist those countries most heavily affected by a smaller scale crisis could avert the need to activate the selective trigger mechanism.

Options

-- Seek to postpone activation of trigger and encourage affected countries to work with not against market forces. This option, if it succeeds, permits delay in creating the economic dislocations inherent in the allocation system and provides maximum flexibility for the market to work. However, it may alienate key allies, especially those where U.S. bases are located.

-- Seek to postpone activation of the trigger by attempting to arrange for alternative supplies at market prices. (Such activity might follow the lines of the effort undertaken in response to a request from Turkey during the 1980 disruption. U.S. companies were contacted by DOE and State officials and asked to assist Turkey in locating oil supplies. DOD's Defense Fuel Supply Center also made an offer of oil products to Turkey.)

This option shows some U.S. willingness to cooperate with affected countries, but avoids any direct expenditure of U.S. funds. The prospects for success of such an option may be limited, however, leading to requests for financial assistance (following option).

-- Seek to postpone activation by mobilizing alternative assistance both in terms of locating supplies and providing credit and/or financial assistance. This option also provides great flexibility and permits a more complete assessment of the real nature of the problem faced by the affected country or countries. Some USG loans or financial assistance would be required. Amounts could be substantial. For example, financing a 10 percent loss in Turkish consumption could require financial assistance up to $125 million per quarter at $40 per barrel.

-- Support selective trigger activation in the event of a request. This option demonstrates to our allies U.S. faith in the IEP system, and as an announced policy would contribute to U.S. interests in the early phases of another selective embargo against the U.S. As a realistic option in the event of a serious crisis, however, it may not provide sufficient time for analysis of the parameters of the crisis if those requesting the trigger activation press their case during the initial stages of the disruption.

2. General Trigger Situation

Analysis - Some countries will seek to trigger the IEA Emergency Sharing System as early as possible in a serious disruption. The U.K. has already informed us that it prefers early activation in order to dampen upward price pressure and discourage speculative buying. Japan may also press for early activation. The IEA consultations prior to activation will provide an opportunity for the U.S. to put forward its own analysis of the severity of the crisis and the likely utility of activating the general trigger. If an attempt is made to pull the trigger quickly, however, the consultations could be extremely brief. Moreover, in the face of substantial pressure from a number of IEA members, the U.S. may not be able to prevent activation unless specific alternatives meeting the

countries' needs are presented.

We will want to give careful consideration to the use of stocks as an alternative to early trigger action. At the onset of a serious crisis, we are likely to be faced with incomplete information on damage which may have occured to key Persian Gulf oil facilities or to be faced with a conflict of uncertain duration. Early coordinated use of stocks could calm markets and add to supplies, allowing a clearer judgement to be made somewhat later on the need to activate the sharing mechanism.

Options

-- Seek to delay activation to the greatest extent possible. This option will provide maximum flexibililty to the U.S., permit markets to clear, permit the gathering of more complete information as to the extent of the crisis before engaging the complicated IEP system, and enable the IEA partners to consult on appropriate measures short of full activation. This option could prove very divisive in terms of a unified IEA approach to the crisis in that it is likely to be unacceptable to IEA members suffering particularly acute supply problems. Given the nature of our IEP commitment, therefore, this option could probably not be exercised in the most severe crises (i.e. case 5).

-- Act with reserve in triggering the system, and urge coordinated stock drawdowns in place of early trigger. This option will help maintain a sense of unity in the crisis, and also may permit a greater exchange of information and views on the crisis than if the U.S. were perceived as holding back from cooperative measures. This option assumes U.S. willingness to discuss and agree on an early coordinated release of stocks.

-- Support early trigger action. This option would meet the demands of those IEA countries most seriously affected by a supply interruption and in the view of most European countries would help calm the oil market during what is potentially the most volatile period of a severe crisis. But information about the nature, depth and extent to the crisis will also be least available during the same period of time. This option is inconsistent with the policy of maximum reliance on markets.

3. Less than Severe (Subtrigger) Disruption

Our analysis indicates that the IEA emergency oil sharing system would not be activated in smaller scale interruptions. Disruptions of 3MMBD or less would not be of sufficient magnitude to cause the "general trigger" to be pulled because they amount to less than 7% of the IEA base period final consumption.

Administration policy is to seek to preserve maximum decision-making flexibility for dealing with interruptions when and if they occur, and to place primary reliance on the marketplace both before and during an energy emergency. This flexibility and marketplace reliance are most important when dealing with a subtrigger disruption, to ensure that the response to such disruptions does not actually increase the economic harm resulting from the disruption. The U.S. has agreed with its IEA counterparts, however, to meet promptly and to consider a variety of actions to avoid serious economic damage to the member countries.

Attachment:
Impacts of the International Energy Program: Data Base and Analysis Group

THE ALLOCATION RIGHTS / OBLIGATIONS OF INTERNATIONAL ENERGY AGENCY NATIONS PRIOR TO ANY MARKET ALLOCATIONS

(2nd QUARTER 1984, MID-ESTIMATE ASSUMPTIONS)

CASE 4

(NET SHORTAGE = 5.0 MMBD, WORLD OIL PRICE = $29)

	NET DISRUPTED IMPORTS	NET IEP IMPORTS	ALLOCATION: RIGHT (+) / OBLIGATION (-)
United States	5.5	4.0	-1.5
Canada	0.0	-0.3	-0.3
Japan	2.9	3.4	0.5
Australia/New Zealand	0.0	0.1	0.1
Norway/Sweden	-0.1	-0.1	0.0
United Kingdom/Ireland	-1.2	-1.1	0.1
Benelux/Denmark*	1.0	1.1	0.1
West Germany	2.0	1.8	-0.2
Austria/Switzerland	0.4	0.3	0.0
Spain/Portugal	0.8	0.9	0.1
Italy	1.1	1.3	0.2
Greece/Turkey	0.2	0.4	0.2

CASE 5

(NET SHORTAGE = 8.0 MMBD, WORLD OIL PRICE = $29)

	NET DISRUPTED IMPORTS	NET IEP IMPORTS	ALLOCATION: RIGHT (+) / OBLIGATION (-)
United States	5.3	3.2	-2.1
Canada	0.0	-0.3	-0.3
Japan	1.9	2.9	1.0
Australia/New Zealand	-0.1	0.0	0.1
Norway/Sweden	-0.1	-0.1	0.0
United Kingdom/Ireland	-1.2	-1.1	0.1
Benelux/Denmark*	0.9	1.0	0.1
West Germany	2.0	1.5	-0.4
Austria/Switzerland	0.4	0.3	-0.1
Spain/Portugal	0.6	0.8	0.2
Italy	0.9	1.1	0.2
Greece/Turkey	0.1	0.3	0.2

*Benelux = Belgium, the Netherlands, and Luxembourg.
Note: Numbers may not be precise due to independent rounding.

TABLE 16

THE ALLOCATION RIGHTS / OBLIGATIONS OF INTERNATIONAL ENERGY AGENCY NATIONS AFTER A FULL FREE MARKET ALLOCATION

(2nd QUARTER 1984, MID-ESTIMATE ASSUMPTIONS)

CASE 4

(NET SHORTAGE = 5.0 MMBD, WORLD OIL PRICE = $57)

	NET MARKET IMPORTS	NET IEP IMPORTS	ALLOCATION: RIGHT (+) / OBLIGATION (-)
United States	3.9	4.0	0.1
Canada	-0.2	-0.3	-0.1
Japan	3.5	3.4	-0.1
Australia/New Zealand	0.0	0.1	0.0
Norway/Sweden	-0.2	-0.1	0.1
United Kingdom/Ireland	-1.2	-1.1	0.2
Benelux/Denmark*	1.1	1.1	0.0
West Germany	1.9	1.8	-0.1
Austria/Switzerland	0.3	0.3	0.0
Spain/Portugal	0.9	0.9	0.0
Italy	1.3	1.3	0.0
Greece/Turkey	0.4	0.4	0.0

CASE 5

(NET SHORTAGE = 8.0 MMBD, WORLD OIL PRICE = $79)

	NET MARKET IMPORTS	NET IEP IMPORTS	ALLOCATION: RIGHT (+) / OBLIGATION (-)
United States	2.9	3.2	0.4
Canada	-0.3	-0.3	0.0
Japan	3.2	2.9	-0.3
Australia/New Zealand	0.0	0.0	0.0
Norway/Sweden	-0.2	-0.1	0.1
United Kingdom/Ireland	-1.3	-1.1	0.2
Benelux/Denmark*	1.0	1.0	0.0
West Germany	1.8	1.5	-0.3
Austria/Switzerland	0.3	0.3	0.0
Spain/Portugal	0.8	0.8	-0.1
Italy	1.2	1.1	-0.1
Greece/Turkey	0.3	0.3	0.0

*Benelux = Belgium, the Netherlands, and Luxembourg.
Note: Numbers may not be precise due to independent rounding.

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ISSUE:

To what degree should we seek consultations and/or coordination with our Allies on stock drawdown issues?

Current Policy

The Administration seeks to preserve maximum decision-making flexibility for dealing with interruptions when and if they occur; however, the U.S. is prepared to consult with its IEA partners to exchange information on the national use of stocks (NSDD-87).

U.S. concerns have centered on maintaining flexibility in deciding the timing and drawdown rate of the SPR, and assuring that control over private sector stocks remains in the hands of the private sector.

Analysis

Several factors are relevant in examining the issue of the degree to which international stock draw coordination should take place. The first is the need to retain control over the use of the SPR. We have invested as a nation over $11 billion in building our SPR. Obviously, we do not want to cede control to other nations over this vital resource.

On the other hand, the U.S. has substantially more stocks than any other importing nation, compared to its import levels. The control of the USG over the bulk of its useable stocks is also more direct than that of other IEA nations. Most other IEA nations hold lower proportions of government stocks or none at all and rely on mandatory stock levels which can be lowered in the event of a crisis. Probably no more that 50% of these commercially held mandatory stocks are useable -- the rest are needed for minimum operating requirements. The leading IEA stock holding nations hold stocks as follows below:

STOCKS ON LAND (January 1, 1984)

COUNTRY	STOCK LEVEL*	DAYS FORWARD CONSUMPTION	DAYS 1983 NET IMPORTS
United States	1,418.25	96	311
Japan	454.5	94	105
FRG	278.25	118	130
Italy	211.5	75	93

*Million barrels (complete table attached)

The above figures can be misleading if the minimum operating requirement is not kept in mind.

It is important to understand that a unilateral release of strategic oil stocks by the U.S. will place an inordinate burden on us and will dilute the effects of the SPR. Because of the integrated nature of the world oil market, a release of stocks from the U.S. SPR will benefit consumers of oil worldwide by providing extra supplies. Administration policy has in fact moved toward early release of the SPR. In his testimony February 21, Secretary Hodel said that "in a major disruption, the early sale of SPR oil in large volumes is ordinarily the best policy for SPR use...The market place needs to know in advance that this is our general policy so that unnecessary panic behavior can be avoided." If the U.S. pursues such a policy of early release, however, other IEA nations may decide to retain their smaller oil stocks against the possibility of a worsening of the disruption. The FRG's policy, for example, is to use its stocks as a last resort measure. Consultations with Europe and Japan may be needed to assure that this does not happen.

Our analysis indicates that rapid use of the SPR in Case II disruption (3 MMBD net disruption lasting six months) would reduce oil prices by $5 to $30 per barrel below what prices would have been had the SPR not been used. Instead of rising to $35 to $75 per barrel, prices are projected to be held to a range of $30 to $45 per barrel. In the event that foreign government controlled stocks were also utilized, prices are projected to be held to a range of $30 to $40 if a disruption took place in the second quarter of 1984. The projected benefits of simultaneous drawdown of foreign government stocks become larger as the disruption size increases. An additional price reduction of $5-15 would take place in Case IV (5 MMBD net disruption) and Case V (8 MMBD) net disruption where foreign controlled stocks are drawn together with the SPR vs. the case where the SPR alone is drawn.

There have been no consultations with our IEA partners on plans for coordination of stock drawdowns to date.

Most European IEA members (but notably excluding FRG) have long argued that some release of government controlled stocks at an early stage of even a small scale disruption could have a beneficial effect in avoiding price run-ups. In the past, U.S. attempts to press for higher stock levels have been met with European demands for use of these stocks in a so-called "sub-trigger" situation, i.e., one in which

the sharing system is not activated. Present U.S. policy continues to be that the market should be allowed to function unimpeded in the event of a small scale disruption.

In a large-scale disruption, coordinated release of government stocks could be considered either before or after activaton of the IEA sharing system. If, for example, conflict in the Persian Gulf disrupted supplies on a major scale, but for an unknown duration, early coordinated use of strategic stocks might be called for as an alternative to immediate activation of the IEA sharing system.

Coordination of stock drawdowns in a trigger situation, may not be feasible. In the event of a severe petroleum interruption and triggering of the IEA sharing formula each member country would be required to limit petroleum imports to levels determined under the formula. Since each member country is permitted to use a range of methods to limit imports e.g., fuel switching, stock drawdown, demand reductions through price or government regulation, any attempt to coordinate stock drawdown will be difficult if not impossible if the IEA is triggered. Therefore, coordinated stock drawdown should be evaluated as an alternative to triggering the IEA.

OPTIONS

-- Coordinated government statements. Attempts by governments at the onset of a serious disruption to lessen the perception of crisis and calm the fears of market participants could be very useful. An internationally coordinated public policy statement encouraging private stock draws, where possible, could have particular effect because of the importance of stock draws in reducing the impact of a disruption. On a worldwide level however, commercial stocks are relatively low and the positive effects of their drawdown would be of marginal utility. Moreover, USG guidance to U.S. companies on when to draw stocks would be inconsistent with a market reliance policy.

-- Seek advance agreement on coordinated release of government-controlled stocks as an alternative to triggering the IEA. A major U.S. concern continues to be that advance attempts at stock policy coordination with our allies would limit U.S. flexibility in SPR policy. Because the U.S. has the highest stock levels, it would face demands by other countries to draw the earliest and at the highest rates. On the other hand, if the U.S. pursues a policy of early drawdown of the SPR, it will be much to our advantage to have other IEA nations drawing their stocks as well. A general coordinated release plan may be necessary to assure a European and Japanese draw.

-- Do not pursue advance agreements, but make decisions on a coordinated stock approach if and when an interruption occurs. This option most closely follows current Administration policy of maintaining maximum flexibility with respect to the use of stocks. In a disruption the size of case 4, and especially case 5, however, it may not permit adequate time to engage in necessary consultations with our allies should we desire to pursue coordination. It may, therefore, result in IEA member government-controlled stocks not being drawn down in the earliest stages of the disruption, thus reducing the ultimate benefits of the drawdown.

-- Assure IEA members that the U.S. favors mutually supportive stock draws, but refuse to establish specific conditions in advance for their release. Instead, we would rely upon consultations to frame the appropriate timing and level of stock draw for a given disruption.

STOCKS ON LAND IN IEA COUNTRIES*

January 1, 1984

	Stock Level MMT	Stock Level Mbbl	Days Forw. Cons	Days 1983 Net Imps.	Days 1981/83 Av. Net Imports
Canada	15.6	117.00	73	-	7,527
United States	189.1	1,418.25	96	311	300
North America	204.7	1,535.25	93	311	324
Australia	4.7	35.25	71	299	222
Japan	60.6	454.50	94	105	184
New Zealand	.7	5.25	63	87	81
Pacific	66.0	495.00	92	110	108
Austria	3.3	24.75	120	140	131
Belgium	5.1	38.25	86	104	97
Denmark	5.0	37.50	147	223	195
Germany	37.1	278.25	118	130	126
Greece	3.7	27.75	119	118	116
Ireland	.9	6.75	68	80	70
Italy	20.2	151.50	75	93	89
Luxembourg	.2	1.50	70	82	80
Netherlands	12.0	90.00	159	283	256
Norway	2.2	16.50	93	-	-
Portugal	2.4	18.00	89	70	72
Spain	10.1	75.75	71	78	73
Sweden	6.4	48.00	116	133	113
Switzerland	6.0	45.00	156	172	174
Turkey	2.0	15.00	44	43	46
United Kingdom	15.7	117.75	70	-	-
IEA Europe	132.3	992.25	96	117	112
IEA	403.0	3,022.50	94	170	170

* A portion of these stocks represent minimum operating requirements for refineries, pipelines, etc. Between 40-60% of privately held stocks are probably unuseable in a crisis.

1. Stock levels adjusted per IEA definitions using crude or equivalent.

2. Products adjusted by 1.065.

3. IEA data is given in metric tons; conversion to barrels is based on 7.5 barrels per ton.

4. Stocks include crude oil and products.

SOURCE: IEA Data

D

ISSUE:

Should the U.S. support coordinated international action to influence the spot market?

Current Policy

Administration policy precludes government intervention in oil markets except in severe petroleum supply disruptions when the IEP is triggered. However, in the event of any disruption, we do support consultations with other IEA countries to assess the magnitude of the interruption and to discuss what, if any, IEA country actions would be appropriate to reduce panic and to minimize economic dislocations. These consultations would include discussion of whether to discourage "abnormal" spot purchases that could further disrupt the market.

Analysis

The crude oil spot market has grown in importance in recent years as demand has weakened, OPEC's share of world oil trade has declined, and purchasers have relied less on long-term contracts. Data on the spot market is difficult to gather because cargoes on the high seas are often sold many times through the spot market before finding their way to refineries. Although no reliable figures are available, we estimate that 20-30 percent of internationally-traded crude oil is never subject to term contracts, and some term contract crude is also eventually resold on the spot market after liftings take place. Hence, what happens to the price of oil on the spot market has a profound effect on term contract prices, including those for OPEC oil.

Spot markets respond both to real supply shortages and political, strategic (preparedness level), psychological, and perceptional factors. Thus, any influence to be exercised over spot market price increases, similar to that attempted by the IEA during 1979-80, must be directed to all these factors as well as to the underlying supply problem. IEA efforts during that period to discourage spot market purchases at excessive prices were accompanied by efforts to spread reliable information on market conditions so as to reduce market panic. However, there is disagreement about the utility of the IEA intervention.

Spot markets can be influenced in two ways. The first and most effective method is to change the fundamentals of

the market, i.e., to decrease demand or to increase supply. Increased production and stock drawdown both provide a deterrence to spot market panic. A second approach is to disseminate information and discourage speculative behavior. Some observers argue that government intervention measures such as "jawboning" oil purchasers have beneficial effects in reducing upward price pressures. Such efforts, it is argued, are likely to have the greatest effect when combined with efforts to gather and disseminate reliable information about market conditions to a broad audience. Others believe that the reverse is true and that such government intervention has perverse effects on market behavior.

In 1980 the IEA Governing Board adopted an overall declaration calling on all members to encourage their companies to avoid spot market purchases wherever possible. This decision was implemented through close coordination among governments. For example, U.S. officials notified the Japanese Government on several occasions when there were reports of Japanese companies making major spot purchases. We in turn contacted U.S. companies to urge forbearance as we became aware of reports of major U.S. activity on the spot market.

Proponents argue that jawboning could limit "panic" purchases and thus "excessive" increases in the world oil price. They base their view on the fact that prices increased at the beginning of the Iranian revolution when there was no jawboning, but did not increase at the outbreak of the Iran/Iraq war, when there was jawboning. Critics of jawboning, however, attribute this difference in price behavior to basic differences in the supply and demand situation.

Some believe that jawboning will in fact make the crisis worse. It may inadvertently bring about panic purchases by the oil companies. The oil companies may view our attempt at jawboning as the first step to more pervasive control over their inventory behavior. Their response might be to buy as much oil as possible before the government imposes inventory controls. In addition, any executive that follows our advice without legal sanction will open himself up to a stockholder's suit. Finally, some believe jawboning may lull government officials into believing that they are effectively addressing the supply disruption and providing an excuse to avoid the more difficult decision of whether or not to use the SPR.

OPTIONS

Allow the market to work unencumbered as it has since 1981, and make no attempt to influence the behavior of market participants. This option is consistent with Administration policy of market reliance. It may be, however,

especially in a situation where drawdown of government-controlled stocks is delayed or perceived by the industry not to be sufficient, that some market participants will engage in activities such as large-volume speculative purchases which, if unchecked, may significantly increase spot market pressures and result in price spikes of the nature seen in 1978/79.

Conduct a public information campaign urging restraint in spot market purchases. This option may help to restrain demand. However, in the absence of legal constraints, we do not know how effective such a campaign would be, and some believe it may be counterproductive. This approach may be seen by some as inconsistent with a market reliance strategy.

As a variant of this option, U.S. oil companies could be advised directly by senior Administration officials that spot market behavior, if it was viewed as excessive by the Congress, could have counter-productive consequences in terms of encouraging price and allocation control legislation.

Argue that IEA members already heavily involved in market activities may act to restrain speculation, while focusing USG activities on stock drawdown and public information. This option would recognize that there is little we can do to influence the activities of the Europeans and Japanese in this area, but would avoid divisive splits in the IEA. (This option and the preceding option could be taken together.)

Take direct action with our IEA partners such as that taken during 1980 by the IEA to influence market participants. This action may restrain demand more effectively than either of the first two options because it combines "jawboning" (seen by some as more effective than a public relations campaign) with dissemination of reliable market information, which, especially in a most serious disruption, may help to calm markets. Others believe this option will be counterproductive and seriously erode the Administration's market reliance policy in that it could also lead to domestic pressure for more substantial intervention in the market.

For instance, jawboning techniques may create a sense of "shortage paranoia" that otherwise may not have existed. Also, jawboning involves the presumption that governments are in a better position to make market decisions than the companies directly involved in it through their daily transactions. But companies refraining from making spot market purchases at the behest of the government may later be disadvantaged, particularly if the disruption worsens and prices, as a result, increase precipitously.

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ISSUE:

Once we have completed a review of our own emergency planning, should we engage in advance bilateral consultations with our allies on triggering the IEA system and other aspects of emergency preparedness?

CURRENT POLICY:

Maintain strong and continued cooperation with other major energy consuming countries to reduce panic, minimize economic dislocations and assure that individual countries do not suffer unacceptable harm as a result of a shortfall in oil supplies To these ends, the U.S. seeks to foster market pricing of energy supplies, to increase stock levels, and to exchange information on national use of stocks. (NSDD-87, p. 9).

BACKGROUND:

The British have on several occasions told us they would welcome consultations on the situation in the Persian Gulf and our views on how to deal with the energy effects of a potential conflict. The Japanese have been active in consulting with the Europeans about IEA and emergency policy, and have also asked for consultations with us. We have undertaken no systematic consultations with other IEA members on energy emergency preparedness issues in connection with the current Persian Gulf situation.

DISCUSSION:

As noted in previous papers, some discretion is provided in the IEP with regard to triggering the IEA System, especially in cases where the duration of an interruption is uncertain. Once a decision has been made within the U.S.G. on trigger policy, we may find it to our advantage to consult with key allies on our rationale and seek their support. This would have the distinct advantage of minimizing disagreement at the onset of a supply crisis.

Such consultations could also involve several other areas such as:

a) coordination of the tenor of public statements to be made at the onset of a crisis.

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b) Exchange of views on parallel attempts to calm the market and assure adequate dissemination of information.

c) consultations and exchange of information on stock draw policies.

d) discussion of developments in the Middle East from an energy perspective.

In addition, we may wish to consult the Canadians with regard to increased exports of natural gas to the U.S. in the event of an emergency. We estimate that Canada has 1.5 MMCF/D of shut-in capacity, 2/3 of which is available to the U.S. under present Canadian export authorizations, and more could be made available in a crisis.

OPTIONS:

a) undertake no consultations in advance of a crisis on the premise that our policies have been adequately explained to our allies. This would preserve maximum U.S. flexibility in dealing with any crisis. No detailed consultations have been undertaken with our allies on energy contingency planning in recent months.

b) undertake consultations in connection with other regularly planned IEA meetings. An upcoming meeting of the IEA Governing Board at the end of March could be used to outline U.S. thinking on energy emergency planning.

c) send two or three U.S. officials to Europe, Canada, and Japan to ensure full allied coordination of preparations to deal with an energy supply interruption. This would allow for more detailed discussion with individual countries of detailed plans and probably result in more effective coordination, but might raise expectations that we are willing to commit to specific SPR drawdown plans. Consider whether these energy consultations should be undertaken together with the politico-military contingency planning being done with our allies.

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ISSUE

To what extent are IEA country stocks adequate? To what extent should efforts be made to increase stocks of IEA member states?

CURRENT POLICY AND BACKGROUND

The International Energy Program (IEP) requires that IEA members maintain an emergency reserve equal to 90 days of net oil imports. A table of current IEA member stock levels is attached. While IEA members on the average hold land-based stock equal to 170 days of net oil imports, the U.S. currently has nearly 300 days of 1980-83 average net oil imports in "land based" stocks. The 90-day requirement, is currently met by all IEA members except Spain, New Zealand, Turkey, Ireland, Luxembourg, and Portugal. It should be noted that these figures represent total oil stocks held in these countries. A portion of these stocks represent minimum operating requirements for refineries, pipelines etc. Between 40-60% of privately held stocks are therefore probably unusable in a crisis, although this percentage may vary according to price.

Discussion

We can pursue several approaches with other IEA members to increase overall IEA stock levels. One possibility would be to press countries with less than 90 days of stocks to comply with the IEP. New Zealand, Ireland, and Luxembourg have 80 days of stocks or more. Portugal, with stocks of 72 days and a weak economy, would have greater difficulty than these countries in meeting the IEP requirement. Stock builds by these countries would not, however, materially affect total IEA stocks in any event. They might, however, reduce pressures in an emergency for trigger activation or for financial assistance.

Stock builds by Spain and Turkey would be somewhat more meaningful. Spain, with consumption of about one million barrels per day, now has 73 days of stocks. Turkey, which consumes about 300,000 b/d, would need substantial investments to double its current stock level from 43 days to the 90 day requirement. Both countries have special military significance, but neither is likely to build stocks without outside pressure. Even with large stock builds by these countries, overall IEA stock levels would not significantly improve, although their individual dependence on the U.S. would be reduced.

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Another possibility involving bilateral efforts would be to ask IEA members that already meet the IEP stock requirement to build their stocks further over the next two years. Further builds by Japan and the FRG, which have the largest IEA stockpiles after the United States and both of which exceed the IEP stock requirement, would be especially helpful. Overall Japanese stock levels exceed the 90 day requirement by 15 days (the minimum operating level requirement, of course, means this figure overstates stocks available in a crisis), but the Japanese have been reluctant for financial reasons to emphasize government stocks. In this regard, Japanese government-owned and controlled stocks are at only 23 days.

We have strongly encouraged the Japanese to increase both overall and government stock levels on many occasions over the last several years, including specific appeals to Japan in the IEA Governing Board. They have responded by resuming the filling of government-owned stockpiles. Despite this movement, Japan remains especially vulnerable to a disruption because of its heavy dependence on imports and on the Gulf as a supplier.

The Germans, with 130 days of stocks, also exceed their IEP obligation. The German equivalent of the SPR contains about 55 million barrels of crude oil, and the FRG also has stocks of petroleum products held by a semi-private company amounting to approximately 100-115 million barrels. These two stocks together equal 90-100 days of German consumption additional to normal commercial inventories.

After the U.S., Japan, and the FRG, Italy holds the largest stocks among IEA members. The Italians are currently at the IEA requirement level but could also be encouraged to build their stocks more rapidly. Taken together, stock builds over current levels by Japan, the FRG, and Italy, could have a significant impact on enhancing Western emergency preparedness generally and in increasing IEA stock level specifically.

We might also work within the IEA to raise the IEP requirement to more than 90 days of stocks, perhaps to 100-110 days. In 1982 we supported an IEA Governing Board decision to increase emergency stock levels. At its December 1982 meting the Governing Board reaffirmed a decision to require that "member countries make efforts not to let stocks fall below" 90 days of net imports. The Governing Board also took a decision to require the calculation to be based on the higher of the average net imports from the previous three calendar years or the average net imports during the single previous calendar year (e.g., during 1984, this would be the larger of 1981-1983 average net imports or 1983 average net imports.) Although the

Governing Board decision did not completely satisfy us, we did not press the issue at that time since the European IEA members linked it to consideration of a stock drawdown in a short supply situation not sufficient to activate the IEA sharing system (the so-called "sub-trigger" situation).

Although we should not be overly optimistic about short-term success in effecting a change in IEA stock requirements, persistence on our part might yield longer-term results and would be responsive to concern on the part of Congress and elsewhere that the U.S. is bearing an unfair portion of the free world's stockpile burden.

Options:

I. Undertake bilateral efforts to persuade those countries below 90 days, in particular Spain and Turkey, to raise their stock levels at least to IEP mandated levels. This would demonstrate to smaller IEA countries that we continue to press them to meet their IEA commitments. Given the financial constraints of these countries, however, chances of success are limited.

II. Press key consumer countries (especially Japan) to raise stock levels by substantial amounts over the next two years. This would have the key advantage of providing significantly higher stocks world wide; however, pressure by the U.S. over the past two years has produced only limited results.

III. Seek an amendment to the IEP raising stock requirements to 100-110 days. Such a change in the IEP would require Congressional approval, opening the way for extensive Congressional consideration of emergency preparedness issues.

IV. Undertake all of the actions described above.

STOCKS ON LAND IN IEA COUNTRIES*

January 1, 1984

	Stock Level MMT	Stock Level Mbbl	Days Forw. Cons	Days 1983 Net Imps.	Days 1981/83 Av. Net Imports
Canada	15.6	117.00	73	-	7,527
United States	189.1	1,418.25	96	311	300
North America	204.7	1,535.25	93	311	324
Australia	4.7	35.25	71	299	222
Japan	60.6	454.50	94	105	184
New Zealand	.7	5.25	63	87	81
Pacific	66.0	495.00	92	110	108
Austria	3.3	24.75	120	140	131
Belgium	5.1	38.25	86	104	97
Denmark	5.0	37.50	147	223	195
Germany	37.1	278.25	118	130	126
Greece	3.7	27.75	119	118	116
Ireland	.9	6.75	68	80	70
Italy	20.2	151.50	75	93	89
Luxembourg	.2	1.50	70	82	80
Netherlands	12.0	90.00	159	283	256
Norway	2.2	16.50	93	-	-
Portugal	2.4	18.00	89	70	72
Spain	10.1	75.75	71	78	73
Sweden	6.4	48.00	116	133	113
Switzerland	6.0	45.00	156	172	174
Turkey	2.0	15.00	44	43	46
United Kingdom	15.7	117.75	70	-	-
IEA Europe	132.3	992.25	96	117	112
IEA	403.0	3,022.50	94	170	170

* A portion of these stocks represent minimum operating requirements for refineries, pipelines, etc. Between 40-60% of privately held stocks are probably unuseable in a crisis.

1. Stock levels adjusted per IEA definitions using crude or equivalent.

2. Products adjusted by 1.035.

3. IEA data is given in metric tons; conversion to barrels is based on 7.5 barrels per ton.

4. Stocks include crude oil and products.

SOURCE: IEA Data

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ISSUE: What should be done to encourage Japan to significantly increase its strategic petroleum stocks in order to be adequately prepared for a severe interruption?

BACKGROUND/ANALYSIS

By far, the largest government stockpile, both in volume and relative to oil import needs, is held by the U.S., followed by Germany and Japan. As a frame of reference, the oil imports, oil consumption and oil dependence for each of these nations for 1982 is provided below:

	Net Oil Imports (MB/D)	Oil Consumption	Imports % of Oil Consumption	Oil as % Total Energy Consumption
United States	4.1	15.3	27	43
West Germany	1.9	2.0	95	39
Japan	4.2	4.2	100	58

As indicated, Japan is by far one of the most highly dependent of the industralized countries on oil imports and consumption.

Comparison of Petroleum Stock Levels

Shown below are current government-owned strategic stocks and government plus private sector stocks. As can be seen, Japan lags behind the U.S. and West Germany in the oil import coverage provided by its government strategic stockpile.

	Government-Owned Strategic Stocks		Total Private and Government Stocks		
	Millions of Barrels	Days of 1982 Net Oil Imports	Millions of Barrels	Days of 1982 Net Imports	Days of 1982 Oil Consumption
United States	385	95	1,440	355	95
Japan	79	19	418	100	100
West Germany1/	55	28	289	149	145

1/ Germany also has about 132 MB (68 days of net 1982 imports) held by a special corporation. We estimate that about 90 MB of the 132 MB are "strategic stocks", in part government financed, for a total of 145 MB or approximately 75 days of net imports.

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Japan has not made much progress in the last year in filling its government stockpile in spite of statements that it wishes to raise the reserve expeditiously to about 190 million barrels. In contrast, the U.S. added 64 MB to the SPR last year. Nor is Japan expected to make much progress in the current fiscal year: JNOC plans to increase its crude oil stockpiles to only 15 million kiloliters (about 93 million barrels) by the end of fiscal 1983. This represents a fill rate of only 50,000 b/d, in comparison to the current U.S. fill rate of 186,000 b/d in 1984 and 145,000 in 1985. Listed below is the fill schedule for the U.S. SPR compared with current Japanese fill. The JFY84 budget proposal to Parliament includes funding to increase the government oil stockpile to about 32 days of net oil imports by March 1985

Date of Completion	Japan (Storage Capacity)	U.S. 1/ (Oil Stored)
	----- Million Barrels -----	
Current Fill	80 (fill)	327
FY 1985		448
FY 1987		520
FY 1988		557

1/ President's Budget assumptions.

At current petroleum prices the capital invested in government strategic stocks is $10.0 billion by the U.S., $2.3 billion by Japan, $1.6 billion by West Germany. By 1985 the U.S. will have 450 MB valued at $13 billion, whereas the Japanese do not appear to have firm commitments to purchase stocks beyond current levels.

SUMMARY

Japan's strategic stockpile program 1983 fill rate and overall size is not adequate in view of their heavy reliance on Middle East oil (50%+ of oil consumption). If the Japanese government reserve reaches 189 MB as planned, this will still only represent about 45 days of net oil imports at the 1982 import rate. Moreover, if this level is only achieved at the rate of the completion of permanent storage (i.e., by FY 1988), the implicit fill rate is only 50,000 barrels per day. In 1983 this low rate was not achieved. 1984 fill plans call for an increase to 32 days of net oil imports at the current import rate.

At the same time, the U.S. is stockpiling at far greater rates (186,000 barrels per day at present) even though we are far less dependent on oil imports. Our main concern is that Japan is not adequately buffered by its own stocks in the event of a disruption. They may not be able to meet its IEA obligations in a

severe interruption and are likely to enter such a market bidding up prices unnecessarily as was the case in 1979. This would place the U.S. in a very awkward position of SPR drawdowns that benefit Japan without a comparable response from GOJ. The GOJ would benefit directly from any U.S. SPR drawdown since additional supplies would lower prices and free up alternate supplies for other importing countries. In effect, the U.S. is providing petroleum supply interruption insurance even though GOJ can afford its own insurance in the case of oil.

OPTIONS

1. Do nothing. We have raised the issue of stock building frequently with the Japanese already and they are making some progress. Raising the issue again at this time risks adding yet another area of contention to our relations with the Japanese.

2. Mount a senior level effort (Secretary, Deputy Secretary) to get GOJ to substantially increase strategic stocks in the near-term if oil markets remain calm. A high-level approach would underscore our great concern over the GOJ's relatively relaxed attitude towards stocks and our belief that adequate IEA stocks are essential to cope with any serious oil supply disruption.

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Issue

SURGE PRODUCTION - Should the U.S. undertake bilateral consultations specifically to seek increased production in the event of a disruption

Current Policy

To develop and maintain positive political, economic and security relations with certain key producer countries to demonstrate that their interests are not served by oil supply disruption. (NSDD-87, p. 9).

1. Analysis

There is presently some 10-12 million b/d surplus capacity available to meet oil supply disruptions. However, virtually none of that is in OECD countries, and over 2/3 (7 mmbd) is located in the Persian Gulf. In prior disruptions, Persian Gulf suppliers, particularly Saudi Arabia, have shown a willingness to increase production. In the event of a closure of the straits, however, most of this capacity may be unavailable.

The producers outside the Gulf with the greatest amount of spare capacity are Libya (0.9 mmbd), Nigeria and Venezuela (0.7 mmbd), and Indonesia (0.3 mmbd). All other producers combined have approximately 0.8 mmbd in available spare capacity. Given the current budget stringencies and prior practice we believe each will be inclined promptly to increase its production, charging what the market will bear. The amount of increased production will take into account both short and longer term revenue requirements. In any event, it will take several weeks to several months to increase production to full capacity and producers may also be concerned about damage to their oil fields from too rapid an increase in production or from maintaining a higher than prudent level of production. On balance, the chances are good that about 3 mmbd of additional production will be available in 30-90 days to offset shortfalls in Gulf production.

Libya is a special case, because its spare capacity is the largest outside the Gulf but also because it alone has traditionally not been characterized as a "high absorber" (i.e., a country with a large population, relatively low per capita income and pressing revenue needs). It could decide for political reasons not to increase its production --

especially if prices rose dramatically, providing higher revenue without increasing his oil production. On the other hand, during two previous periods of tight supply (the 1973-74 Arab oil embargo and the collapse of the Shah's regime in Iran in 1979), Libya did take advantage of the market. It did this in 1973 even while it was stridently attacking U.S. Middle East policy.

The USG maintains contacts with the producer countries, and during a crisis would in any event seek information on current and projected production, along with diplomatic exchanges on the events. Because prior practice and economics would favor increased production, specific exchanges seeking an increase would be of marginal benefit. In fact, one can argue that such approaches might cause producers to make demands on us in return for their acceding or promising to accede to our wishes.

2. Recommendation:

The IESG recommends that no pre-crisis diplomatic contacts be undertaken with producer nations to seek increased production in the event of a crisis. It is likely that all OPEC producers would raise production close to maximum levels in a major disruption. Pre-crisis approaches might only expose us to political and economic demands for something which would probably happen in any case. If and when an interruption occurs, we would then consider approaches as necessary to any producer which might be reluctant to increase production to maximum levels.

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Pre-Crisis Contacts to Deter Escalation
(Information Paper)

Background

Since its inception, the Iran-Iraq war has posed a threat to the security of Persian Gulf oil supplies. Iranian actions earlier in the war, combined with closure of the Syrian pipeline, have already cut Iraqi exports from 3.3 million b/d to 800,000 b/d. In the summer of 1983, Iraq moved to acquire weapons systems giving it the capability to interdict, at lower risk, Iranian exports. Iraqi use of Super-Etendard aircraft, delivered by France last fall, to launch Exocet missiles against tankers in the Gulf could keep ships from loading at Iran's Kharg Island terminal. Iraq may have the capability to damage facilities at Kharg.

Iraq has thus far not made a concerted effort to halt Iran's oil exports. Until recently, it was contemplating the possibility of resuming its own Gulf exports through a limited cease-fire with Iran. Our continuing efforts and those of others to stave off escalation in the Gulf may also have influenced Iraq to exercise restraint. However, the Iraqi Government has recently reiterated in strong terms its warning that all shipping is subject to attack in the war zone it has declared in the northern Gulf; the statement emphasized that this policy applied to tankers calling at Kharg, and reports of Iraqi attacks on tankers are increasing. Iran has responded by threatening to stop the export of all Gulf oil if its own exports are halted.

U.S. Policy

Concerned about the growing danger of a disruption in the flow of oil from the Gulf, the U.S. has undertaken several initiatives to reduce the likelihood of escalation. We have focused these efforts on convincing Iraq that alternatives to military action exist that either promise movement toward a cease-fire or would stabilize its financial position vis-a-vis Iran, permitting it to carry on the war should Iran continue to refuse to negotiate.

On the diplomatic front, we fostered UN Security Council Resolution 540 calling for a cease-fire in the Gulf, and we are urging the Secretary General to reactivate UN mediation efforts. Iran has refused to make a formal commitment even to a limited cease-fire, and we are encouraging others to explore the possibility of an informal understanding guaranteeing the security of both belligerents' oil facilities and exports in

the Gulf. In particular, we support Japan's playing such a role.

We have urged Saudi Arabia and the other Gulf states to increase financial assistance to Iraq, either directly or by the sale of oil on Iraq's account. Our own decision to grant $400 million in CCC credits to Iraq financed basic food imports when Iraq's need for credit was particularly acute.

We are also encouraging Iraq to develop additional oil export outlets in order to relieve financial pressures. Options currently being pursued by Iraq include a 500,000 b/d link to Saudi Arabia's Petroline and a pipeline to the Jordanian port of Aqaba that would carry 1 to 1.5 million b/d. Even the prospect of added oil earnings would provide a basis for creditors to continue to accommodate Iraq.

Iraq has made clear that it retains, and eventually may exercise, the escalation option if international pressures on Iran have no effect. Iraq may again find itself facing a financial crisis if progress on alternate export routes is slow. Likewise, the military and psychological pressures of sustaining a war of attrition with a larger and potentially more powerful adversary may in time cause Iraq's political structure to crack. Consequently, the danger of a desperate recourse to escalation remains, and its likelihood increases in proportion to whatever success Iran may achieve in its current offensive. In pointing out to Iraq the consequences of such an action on its part, we have cautioned that an escalation of the war will not draw us into the conflict on the Iraqi side and that the direct involvement of outside powers poses unpredictable risks.

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ISSUE:

Should we engage in either pre-crisis or crisis contacts with member states of the GCC and OPEC to attempt to minimize a supply disruption, and if so, on a bilateral or multilateral basis.

CURRENT POLICY:

Develop and maintain positive political, economic and security relations with key producing countries to demonstrate that their interests are not served by oil supply disruptions, to develop economic relations that reinforce the production and exchange of oil and to assist these countries, as appropriate, in their defense against outside agression and internal unrest (NSDD-87, p.9). We have consistently avoided putting such contacts on a multilateral (p. ex., IEA-OPEC) basis.

BACKGROUND:

Last summer French Minister of External Affairs Cheysson proposed an informal producer-consumer dialogue, a call which has been picked up and echoed by Venezuela and most recently by the Swiss. The Swiss tried to sell their proposal by emphasizing that it would provide a communication channel that could be useful in a supply disruption. A Swiss official discussed the idea in early December with Yamani who allegedly was enthusiastic.

The Swiss approached us with their idea. We reacted negatively, restating opposition to formal or informal multilateral producer-consumer dialogue. The Swiss then made demarches to most IEA capitals and later reported to us that no nation was as negative as the U.S., but most countries were skeptical. In view of the negative reaction, the Swiss have informed us they intend to drop proposal.

U.K. officials have also advised us that they have heard that the Saudis might be interested in multilateral discussions focussing on energy contingency planning in the event of a Persian Gulf closure. The British are skeptical about the value of such an exercise.

On January 11, New Zealand Energy Minister W.F. Birch met with Yamani. The press release issued after the meeting noted that Birch urged a greater exchange of information between IEA and OPEC, implying a positive attitude toward a multilateral approach. Although Birch served as Chairman of the 1983 IEA Ministerial, he was given no mandate from IEA countries as a group to make such a suggestion. The USG subsequently notified our embassies that our position is unchanged.

DISCUSSION:

We see nothing to be gained by a pre-crisis multilateral meeting with OPEC. We fear that any such discussion would inevitably lapse into a debate over pricing and production levels, both of which we consider best determined by the marketplace. Our IEA allies seem, for the main part, prepared to go along with this position.

Furthermore, we question whether there is genuine interest on the part of OPEC since statements by Yamani can be variously interpreted. We have had no direct approaches from the Saudis proposing a dialogue with consumers.

Pre-crisis discussions with individual GCC or OPEC counties would likely be more frank and open, and thus contribute to a more fruitful exchange.

The European Community meets regularly on a technical level with the GCC, and such meetings could be used, if it appears necessary, to sound out the Gulf producers on physical security issues.

The possibility of discussion during a crisis with a selective group of countries bordering the Persian Gulf should not be ruled out at this time.

Recommendation:

The IESG recommends that no multilateral contacts between oil producers and consumers be undertaken at this time. Despite tentative approaches from producers to European IEA members, we remain unclear as to what could usefully be discussed in such a dialogue. In all likelihood, we would face producer requests for price stabilization agreements which would run counter to U.S. policy. We would, however, continue a full range of bilateral contacts with oil producing states.

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INTERAGENCY INTELLIGENCE ASSESSMENT
12 March 1984

IRAN-IRAQ WAR:
Escalation Scenarios and Threats to Persian Gulf States

We believe the warnings about possible escalation of the Gulf war contained in SNIE 34/36-2-83 dated October 1983 remain valid. The SNIE predicted a series of intermediate escalatory steps by Iraq to increase military pressure on Iran, possibly culminating in Iraqi attacks on Iran's Khark Island oil terminal or associated tanker traffic and Iranian retaliation against oil exports from Arab Gulf states. We believe Iraq already has passed through many of the intermediate warning steps outlined in the SNIE.

The risk of a serious Iraqi effort against tankers or Khark Island will increase if, as expected, Iran launches its next major offensive, probably within a month. A serious Iraqi effort against Khark is particularly likely if the battle goes badly for Baghdad. On paper Iraq has the capability to shut down Khark Island through direct military attack or attack on tankers calling at Khark. Iraqi willingness to risk heavy losses in such efforts is the question.

As we noted in the October SNIE, the result of Iraq's initial attacks on Iranian oil exports from Khark is not likely to be clear cut. Should sporadic or limited Iraqi attacks cause only a modest interruption in Iranian oil export we believe Iran would choose options at the lower end of the escalatory scale.

This Interagency Intelligence Assessment was requested by the National Security Council Staff. It was prepared under the auspices of the National Intelligence Officer for Near East and South Asia. The Assessment was coordinated at the working level with the Central Intelligence Agency, the Defense Intelligence Agency, the National Security Agency, the Department of State, and the intelligence services of the U.S. Army and Marine Corps. Information available as of 12 March 1984 was used in preparation of this Assessment.

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At a minimum, we believe the Iranians will employ psychological warfare through the use of Iranian inspired and supported Shia terrorism directed at Iraq's Gulf supporters as well as US personnel and facilities in the region and beyond.

Iran might also execute some of the lower risk options if its new offensive is defeated by Iraq.

Lower Risk Options

As discussed in the SNIE, Iran has numerous options for retaliation but we believe the Iranians would first try to choose optons which Tehran felt would not provide a pretext for Western military intervention. We continue to believe that trying to shut down the Strait would be Iran's last step in escalating the war. We believe lower-risk options include:

-- overflight of off-shore Arab Gulf oil facilities and terminals or shipping bound for them by Iranian combat aircraft.

-- random detention and search of bulk shipping carriers bound for Arab Gulf ports for contraband

-- further air raids against targets in Kuwait

-- attacks against Iraq's remaining oil exporting facilities, including the Iraq-Turkey pipeline.

Should Iraq inflict serious damage on Khark--through which 90 percent of Iran's oil is exported--or cut off tanker traffic to Khark for a prolonged period, we believe Iran would react more sharply.

More Serious Steps

Tehran probably recognizes that its other two escalatory options would carry a significant risk of confrontation with the US. They are:

-- military actions against Saudi Arabia or the Arab states of the lower Gulf. This would include naval air or commando attacks against off-shore or on-shore Arab Gulf oil facilities, desalination plants, or other economic targets.

-- disruption of Gulf oil shipping. This could range from a declaration that the Strait had been closed or mined--a bluff that initially probably would be respected by most shipping--to a direct air and naval action, including mining, to force the closure of the Strait to commercial traffic. It would entail continued attacks against tankers in the Gulf even if the Strait was cleared.

We believe these scenarios would occur roughly in the order stated. We cannot, however, rule out simultaneous use of some actions. Terrorism could be expected to form a backdrop to any of the above.

Iranian Perceptions

Iran does not view the Gulf War in isolation, but as part of a broader struggle to advance fundamentalist Islam and reduce Western influence in the region and beyond. In the wake of events in Lebanon, Iran may feel more confident of its ability to oppose the US in the Gulf over the long-term.

We judge Iran does not want to draw US forces into the Gulf. Should US forces become involved, however, Iran's clerical leaders might find it in their interest to keep the US engaged in a protracted conflict. It would provide the regime with an increased threat to rally the Iranian population. The Iranians could step up terrorist attacks against US targets in the region and elsewhere to demonstrate US inability to protect itself. Tehran also would be likely to adopt a drawn out strategy of sporadic harassment of oil shipping and facilities under the assumption that it could outlast the US and that the US would be restrained in its ability to hit back at Iran because of the Soviet Union.

Gulf State Vulnerability to Terrorism and Subversion

Given the success of Iranian backed terrorism in Lebanon we would expect to see Tehran put special emphasis on the use of terrorism and subversion in the Gulf. Iran clearly has the capability to instigate assassination and terrorist attacks by Shia. More than a thousand Gulf Shia have received guerrilla training in Iran in the past five years. Many of these Shia are in place in the Gulf states and can execute terrorist operations on short notice.

We doubt that the Shia will be able to directly seize power in any of the Gulf states, with the possible exception of Bahrain. The Gulf security services probably can handle minor incidents, such as protest demonstrations by Shia in their countries, but they cannot prevent the more likely acts of terrorism and subversion. Most of the services are plagued by inadequate training, bureaucratic rivalries, and poor coordination. In addition, long and inadequately monitored coastal borders complicate efforts to block saboteurs.

Gulf Security Services

The security services in the Gulf states vary in effectiveness. The British-run Bahraini and Omani services have proved themselves capable of early detection of subversion and terrorist threats and have excellent counterterrorism capabilities. Bahrain, however, remains susceptible to Iranian-sponsored subversion because of its large Shia population.

The security services of Kuwait, the UAE, and Qatar have not effectively penetrated their Shia communities. None is likely to know in advance of terrorist operations against them. The resources of the Kuwaiti services were stretched to their limit in responding to the bombings in December. We believe the services of Qatar and the UAE would be similarly hard pressed.

Despite stepped up security measures in the wake of the Kuwaiti bombings, serious weaknesses in Saudi internal security remain. While still inadequate to completely control terrorism, the Saudi security services have a heightened awareness of the problem and have begun to take steps to improve defenses against pro-Iranian terrorist attacks. Saudi borders--especially the long eastern shoreline--are difficult to secure adequately and are highly susceptible to penetration. In addition, Shia make up one-third of the work force in the Saudi oil industry.

Gulf State Vulnerability to Iranian Military Action

Iran has the capability to conduct a variety of military operations against Gulf targets. Tehran's overall military capabilities have been diminished greatly through 3 1/2 years of war and the US arms embargo. The Iranian Navy's capability has suffered due to purges in leadership and limited availability of spare parts and weaponry but it is capable of supporting unconventional warfare activities directed at the Gulf states. Iranian Fighter/Bomber aircraft are only about 35% operational leaving approximately 85 aircraft for all air force missions. The Air Force could use some of these aircraft to conduct strikes against Gulf Arab targets in a sequential or combined operation.

Defense Capabilities

The air defenses of the Gulf states would be unable to prevent some Iranian aircraft from reaching important targets. Kuwait is particularly vulnerable, given its proximity to Iran. Saudi Arabia has the largest and best-equipped Air Force of any Gulf state, but it could not react to an Iranian attack quickly enough to fend it off. Even with warning from US AWACS monitoring the Persian Gulf, the Saudis would have no more than 15 minutes to respond to aircraft approaching from Iran.

The Omanis and Saudis possess a capability to retaliate against Iran with air strikes. Although such attacks might be helpful in limiting Iran's ability to inflict damage, they probably would also contribute to Iran's aim of rendering the Gulf as a whole unsafe for continued maritime commerce, further isolating Gulf Arab oil terminals.

Southern Gulf coastal and offshore oil facilities are vulnerable to Iranian naval/commando attacks, as was demonstrated by the damage done to the Iraqi offshore oil terminals in the early months of the war. The Saudis, however, are improving their defenses, especially at the critical oil export facility at Ras Tanura.

Oil tanker traffic is the portion of the Gulf oil export process most vulnerable to Iranian interference. Iranian harassment of oil tanker traffic might be prolonged as Iran tries to demonstrate that the US is unable to effectively protect tanker traffic. Moreover, even the destruction of the bulk of Iran's air and naval forces would not necessarily end the threat as Iran could use dhows, small boats, and light aircraft to continue harassing tankers. Such Iranian threats could require Western navies to convoy tankers for months.

Impact of the Escalation Scenarios on Oil

The potential for oil price increases would be limited so long as Saudi Arabia can use its oil producing capacity to continue supporting the current oil price. It would take the unlikely event of major disruption to Saudi oil exports to substantially change this picture. Two types of Iranian actions could reduce Gulf oil exports to the point that free world oil supplies would be significantly disrupted. These circumstances are:

-- Successful coordinated Iranian attacks against the Ras Tanura Juaynah oil terminals and the processing facilities at Abqaiq. Such a major attack might shut down Saudi oil activities for up to two months, after which production would begin to recover, perhaps returning to the 5-6 million b/d level in an additional 3 to 5 months, with US assistance.

-- Sustained and successful Iranian attacks against tanker traffic in the Straits and the Gulf.

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International Oil Market Outlook: Midyear Assessment (U)

An Intelligence Assessment

Secret

GI 83-10171
July 1983

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International Oil Market Outlook: Midyear Assessment

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An Intelligence Assessment

This paper was prepared the Office of Global Issues. Comments and queries are welcome and may be directed to the Chief, Strategic Resources Division

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International Oil Market Outlook: Midyear Assessment

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Key Judgments

Information available as of 8 July 1983 was used in this report.

Recent gains in OPEC oil production and a firming in spot oil prices have signaled a return to more stable conditions in the oil market. OPEC members have largely followed the production and pricing guidelines set in March. Even non-OPEC producers appear determined to avoid triggering a price drop.

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Although non-Communist consumption has continued to fall and inventories are being depleted, the willingness of producers to cooperate and prospects for a sustained economic recovery should, in our view, cause prices to hold through December. In the absence of a sustained economic recovery and a resultant rebound in oil use, the willingness of financially pressed producers to hold the line on prices is likely to wane.

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Even if OPEC holds the line on prices through yearend, oil market conditions will remain soft and the cartel will continue to face a number of problems in the next year or so. One major hurdle will be the manner in which OPEC members establish quotas when demand exceeds the present 17.5-million-b/d ceiling. Because of pressing financial needs, we believe there will be a great temptation to produce too much too soon. If consumption continues to fall, major oil companies would accumulate excess inventories and cause a return to the weak market that prevailed in early 1982 and 1983. An unexpected end to the Iran-Iraq war in the coming months and attempts by these two countries to raise production would also sharply increase downward price pressures.

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International Oil Market Outlook: Midyear Assessment

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Introduction

The oil market has been in turmoil over the past two years as producers have attempted to adjust to sharp declines in revenues as a result of rapidly dwindling demand for oil. In an unprecedented move this past March, OPEC members cut the price of the benchmark crude, Arab Light, by $5 per barrel and established an overall production ceiling of 17.5 million barrels per day for the group, nearly 14 million b/d below 1979 production levels. Despite the considerable differences among OPEC members especially concerning revenue needs, the group has generally adhered to the March production and pricing guidelines and prevented a major collapse in oil prices. Although some stability has returned to the oil market in recent weeks, the cartel has by no means regained control of the market. Whether the organization will prevent a further decline in prices over the coming year or so will depend on a number of factors, the most important of which is an increase in oil consumption.

Recent Trends

Consumption Patterns. The decline in oil consumption continues. Based on oil industry data, we estimate that non-Communist oil consumption fell by about 5 percent during first-quarter 1983, the 14th consecutive quarter that oil sales have declined from year-earlier levels. Partial data for the second quarter indicate that the decline in oil sales is continuing, albeit at a slower rate than in 1982. Oil consumption in the United States and Italy fell by 3 percent in April-May. During the same period oil sales in France approximated year earlier levels.

In addition to sluggish economic activity in major industrial countries and continued conservation, several other factors have contributed to the decline in oil sales in recent months:

- Relatively warm weather from September to April caused heating requirements in the seven major developed countries combined to fall 10 percent below year-earlier levels.
- Appreciation of the dollar has pushed up imported oil costs in some foreign countries despite lower official oil prices. From January 1982 to January 1983, the price of imported crude oil in France and Japan, for example, rose 9 percent and 2 percent, respectively, while the average OPEC official sales price declined by 3 percent. (Crude oil prices are denominated in dollars.)
- LDC austerity programs also contributed to the drop in consumption.

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Inventory Adjustments. Industry expectations of a price decline caused a large inventory liquidation in recent months, contributing to the depressed demand for OPEC oil. We estimate that primary oil stocks fell by about 4 million b/d during the first quarter, nearly 500,000 b/d greater than the normal seasonal rate. As a result, non-Communist oil stocks on land declined to about 3.9 billion barrels at the end of the first quarter, about 92 days of forward consumption (table 1). We believe secondary and tertiary stocks—oil held by wholesalers, retailers, and users—were also drawn down in anticipation of an oil price decline. Because of the historic relationship between stock levels and consumption, stocks at the end of March were still above normal by about 100-200 million barrels, representing two to four days of forward consumption. Our estimate of consumption and current supply levels indicates that commercial inventories during the second quarter held roughly steady or declined by as much as 1 million b/d. This is in marked contrast to a normal seasonal buildup.[1]

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[1] Because of historic seasonal fluctuations in the level of oil consumption, non-Communist primary oil stocks are normally accumulated during the spring and summer months. The buildup is usually about 1.5 million b/d during the second quarter and approximately 2.5 million b/d during the third quarter. These stocks are then depleted during the fall and winter to meet peak consumption needs. The drawdown is normally about 1 million b/d during the fourth quarter and about 3 million during the first quarter.

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Table 1
Non-Communist Primary Oil Stocks on Land, End of Period [a]

	Billion Barrels				Days of Forward Consumption			
	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
1978	3.6	3.7	3.9	3.9	74	76	74	69
1979	3.5	3.8	4.2	4.3	72	78	81	82
1980	4.3	4.6	4.8	4.6	91	99	97	93
1981	4.5	4.6	4.7	4.6	101	104	100	96
1982	4.3	4.2	4.3	4.3	97	98	97	96
1983	3.9 [b]				92 [b]			

[a] Estimates include government-owned stocks in Japan and the United States that have increased from 18 million barrels in first-quarter 1978 to about 385 million barrels at end of first-quarter 1983. The increase amounts to about nine days of forward consumption.
[b] Estimated.

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Table 2
OPEC Crude Oil Production

Million b/d

	1982	1983								
		Quota	January	February	March	First Qtr	April [a]	May [a]	June [a]	Second Qtr [a]
Total	**18.8**	**17.5**	**17.0**	**14.9**	**15.9**	**15.9**	**15.9**	**17.4**	**17.4**	**16.9**
Algeria	0.6	0.725	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Ecuador	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Gabon	0.2	0.15	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Indonesia	1.3	1.3	1.2	1.0	1.1	1.1	1.4	1.4	1.3	1.4
Iran	2.3	2.4	2.7	2.5	2.6	2.6	2.3	2.3	2.3	2.3
Iraq	1.0	1.2	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Kuwait	0.7	1.05	0.6	0.8	0.9	0.8	0.7	0.8	0.7	0.7
Libya	1.2	1.1	1.4	1.2	1.3	1.3	1.1	1.1	1.1	1.1
Neutral Zone	0.3	[b]	0.3	0.2	0.2	0.2	0.4	0.5	0.4	0.4
Nigeria	1.3	1.3	0.8	0.7	0.9	0.8	1.2	1.6	1.5	1.4
Qatar	0.3	0.3	0.3	0.2	0.2	0.2	0.3	0.3	0.3	0.3
Saudi Arabia	6.3	[c]	4.6	3.6	3.6	3.9	3.9	4.6	4.9	4.5
UAE	1.2	1.1	1.2	1.1	1.1	1.2	1.2	1.2	1.2	1.2
Venezuela	1.9	1.675	2.1	1.8	2.1	2.0	1.7	1.7	1.7	1.7

[a] Preliminary.
[b] Neutral Zone production is shared about equally between Saudi Arabia and Kuwait and is included in each country's production quota.
[c] Saudi Arabia has no formal quota; will act as swing producer to meet market requirements.
Note: Because of rounding, columns may not add up to totals shown.

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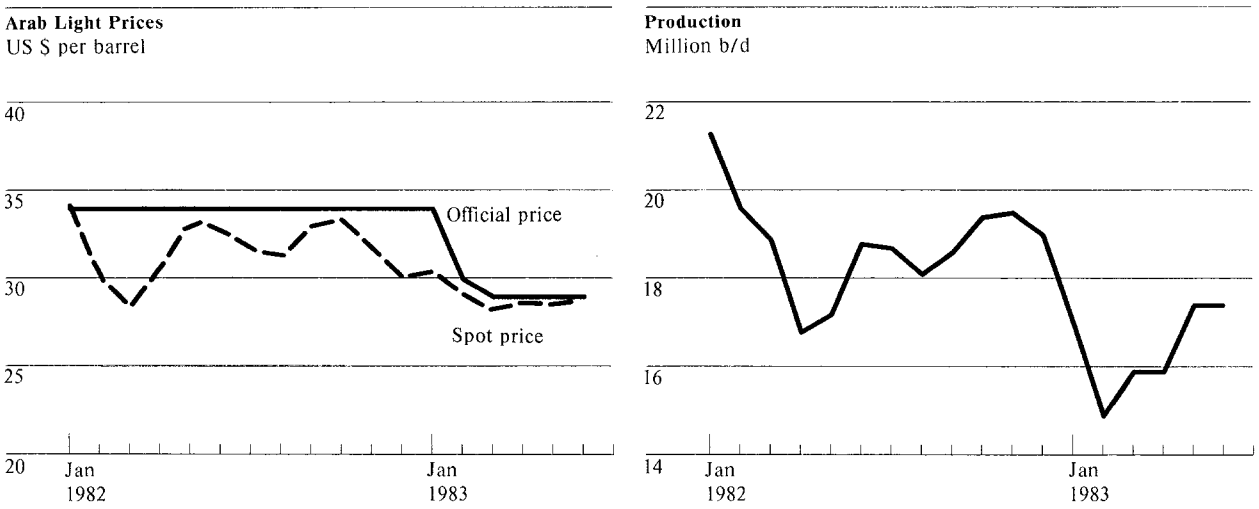
OPEC: Crude Oil



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Production Trends. Preliminary data indicate OPEC crude oil production in June averaged 17.4 million b/d, more than 1 million b/d above April levels and approaching the cartel's production ceiling of 17.5 million b/d set in March (table 2). Nigeria, the UAE, and Indonesia are the only nations to have exceeded their individual production quotas; second-quarter production in all three nations was close to 100,000 b/d above their ceilings. Saudi production in June rose 300,000 b/d from May to 4.9 million b/d.

OPEC producers—including Iran, Libya, and Venezuela—continued to produce within their allocation levels in support of the OPEC agreement.

Major non-OPEC exporters have also signaled their intentions not to undermine the price structure. According to statements made by senior Mexican oil officials, Mexico has adopted a temporary 1.5-million-b/d export ceiling even though Mexico is having financial problems and could export nearly 2 million b/d. The duration of this measure, however, remains unspecified. While maintaining output at near-capacity levels, the United Kingdom dropped prices only slightly in April.

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Recent Price Developments. In addition to producer willingness to hold down production, a number of other factors have contributed to the stability of oil prices since OPEC lowered the official sales price of Arab Light crude oil by $5 last March to $29 per barrel and established production quotas (see charts):

- Buyer acceptance of the British National Oil Company's minimal price reduction in April and the lack of retaliatory cuts by Nigeria and other OPEC members helped firm prices.

Table 3
Oil Price Trends 1983

US $ per barrel
(end of month)

	February	March	April	May	June
Arab Light					
Official	30.00	29.00	29.00	29.00	29.00
Spot	28.00	29.00	28.85	28.60	28.90
Yield	25.54	26.57	28.02	27.31	27.49
Kuwait Medium					
Official	28.30	27.30	27.30	27.30	27.30
Spot	27.50	26.25	27.25	26.95	27.10
Yield	24.69	25.67	27.05	26.31	27.26
Bonny Light					
Official	30.00	30.00	30.00	30.00	30.00
Spot	28.00	28.50	30.00	29.75	30.20
Yield	26.54	27.82	29.40	28.81	29.65

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- The Soviet Union and Egypt announced an increase in their official oil prices of about 50 cents per barrel effective 1 May, and both announced a further 50-cents-per-barrel increase effective 1 July. Soviet prices are now in line with the OPEC benchmark.

Spot crude oil prices continue to fluctuate around official prices. Arab Light prices are now only 10 cents below the official price, while spot crude prices for Bonny Light are running about 20 cents above the official level (table 3). We do not believe the modest spot price movements reflect a major market trend,

Demand Outlook

Consumption Factors. Oil market conditions during the remainder of this year will depend in large part on consumption trends. Predicting consumption patterns, however, is difficult:

- Forecasters have limited success in predicting the sharp decline in consumption during the past few years. Estimates differ on how much of the decline was due to conservation versus the recession. There is also considerable uncertainty regarding the amount of additional investment in energy efficiency that is under way despite recent declines in real and nominal oil prices.

- The pace of economic activity and its impact on oil consumption are uncertain. Many forecasters believe a recovery will bring a rebound in oil use because increased activity in energy-intensive industries and oil's traditional role as a swing fuel should bolster oil demand.

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- Accurate and timely data on end-user consumption of oil is not available. The apparent consumption measured by companies includes secondary and tertiary stock movements, the effect of which cannot be easily separated from actual oil use. If, as we expect, significant drawdowns of these stocks occurred in early 1983, a reversal in this trend could cause major international companies to overestimate final consumption in second-half 1983, unnecessarily boost imports, and wind up with excess oil stocks.

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Inventory Behavior

The exact level of usable stocks held by companies is a function of their market outlook and company strategy as well as miscalculations in balancing supply and demand. In addition to minimum operating levels, compulsory stocks, and government-owned stocks, inventory levels include a residual that cannot easily be fine-tuned to match a company's financial objectives. Factors influencing stock decisions include:

- *Estimates of future consumption levels, including the strength of economic recovery.*
- *Expectations about price movements.*
- *Expectations about supply availability, particularly stability in certain key oil-producing nations.*
- *The level of interest rates.*

- Fluctuations in currency exchange rates will cause oil prices, and hence consumption, to vary among countries.

Consumption Outlook. To assess the market outlook for the balance of 1983, we have examined two scenarios for oil consumption. Under our base case, we assume the economic recovery combined with erosion in real oil prices raises oil consumption to year-earlier levels in the fourth quarter. Although the OECD economies now appear to be pulling out of the recession, the recovery is neither uniform nor rapid. Most economic consulting firms expect growth in the United States and Japan, for example, to outpace growth in Western Europe. These same forecasters expect average OECD growth to approximate only 2 percent for the year. To accommodate the uncertainty about economic recovery and the possibility of continued high rates of conservation, we have also examined an alternative case that assumes that the rate of decline in oil consumption continues at its recent pace through 1983. Under both scenarios we assume LDC oil consumption remains relatively flat. In estimating annual oil consumption, we adjusted results from the CIA econometric model on the basis of our review of recent industry projections. In estimating quarterly oil demand, we constructed a set of quarterly growth rates consistent with the pattern of recovery forecast

Inventory Behavior. Movements in oil inventories will play a key role in determining the level of oil demand for the balance of this year. Companies still have some leeway to reduce stocks and probably will strive to keep inventories at minimum levels. Our base forecast assumes that at some point in the next few months, however, inventory depletion will be halted, either because stocks will be approaching minimum levels or companies perceive that the price decline is over. Because they have different levels of inventories, some companies may have already ceased depleting stocks, which probably accounts for the recent rise in OPEC production. On balance, the resumption of normal inventory patterns later this year alone could raise oil demand by nearly 2 million b/d. Under our alternative case, we assume excess inventories remain through 1983 because international oil companies continue to overestimate future consumption levels, in part because of their inability to obtain accurate and timely data on end-user consumption of oil. 25X1

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Near-Term Price Outlook

The Base Case: Prices Hold. Should oil consumption rebound and inventory patterns return to historic patterns during second-half 1983, demand for OPEC oil, including natural gas liquids, would increase to about 20 million b/d by the fourth quarter (table 4). Such an increase should help underpin the present pricing structure and lessen pressures for some OPEC members to cheat on their quotas. OPEC members appear determined to prevent a further slide in oil prices, and production controls would remain essential to maintaining price stability. We expect OPEC members to have difficulty apportioning new quotas once demand exceeds the present level. 25X1

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Alternative Forecast: Price Weakness. Should the lower consumption case materialize, demand for OPEC crude oil would average roughly 17.5 million b/d during second-half 1983, approximating the current OPEC ceiling. Under this scenario OPEC members would have difficulty preventing a further price decline. If OPEC production increases overshoot actual consumption levels, excess stocks would persist and spur another downturn in demand for OPEC oil this

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Table 4
Estimated Non-Communist Oil Supply and Demand

Million b/d

	Base Case									
	1982					1983				
	I	II	III	IV	Year	I	II	III	IV	Year
Consumption [a]	47.5	44.0	43.2	44.6	44.8	45.0	42.5	42.8	45.4	43.9
Inventory change [b]	−3.3	−1.8		0.2	−1.2	−4.2	−0.8	1.6	−1.2	−1.1
Supply	44.2	42.2	43.2	44.8	43.6	40.8	41.7	44.4	44.2	42.8
Non-OPEC	23.3	23.6	23.8	24.4	23.8	24.1	24.2	24.4	24.4	24.3
OPEC	20.9	18.6	19.4	20.4	19.8	16.7	17.5	20.0	19.7	18.5
						Low Consumption Case				
Consumption						44.7	42.0	41.0	43.0	42.7
Inventory change						−3.9	−0.3	1.9		−0.6
Supply						40.8	41.7	42.9	43.0	42.1
Non-OPEC						24.1	24.2	24.2	24.3	24.2
OPEC						16.7	17.5	18.7	18.7	17.9

[a] Includes refinery gain.
[b] Includes stock change afloat.

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winter. Under these circumstances and without a sustained rebound in oil consumption, serious price pressures could return in early 1984, repeating the pattern of the previous two years.

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Another key in the near-term market outlook will be the behavior of non-OPEC producers. Although oil market stability remains in their interest, we believe coordination with OPEC would wane if oil demand drops sharply:

- Renewed market weakness would pressure Mexico to lower prices, given its financial difficulties and its desire to sell up to its export capacity.
- The United Kingdom would face increased pressure to cut prices if sales plummet as a result of market weakness or attempts by other exporters to increase their market share.
- The Soviet Union would be among the first to shave prices to maintain volume and ensure vital hard currency earnings.

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Pressure on Exporters

The financial strain facing most members of the cartel pressures each one to maximize production and exports without regard for the others. Even under our base case demand estimate for 1983, OPEC would experience a current account deficit of about $30 billion. Only five OPEC states are likely to run a surplus in 1983—Kuwait, Qatar, Iran, the United Arab Emirates, and possibly Gabon. Most of the deficit countries are already in financial trouble and these problems could intensify, especially if the banking community moves to constrain lending to these countries. Should demand for OPEC oil fall 1 million b/d lower than our base case, the current account deficit would rise by about $10 billion unless offsetting import cuts were made.

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Industry Forecasts

A survey of recent short-term oil market forecasts [redacted] *indicates expectations of a continued soft market through at least yearend. Most forecasters expect the current price structure to hold through 1983. Some analysts, however, call for renewed downward price pressures later this year, especially if the rebound in oil use fails to materialize.* [redacted]

Most companies anticipate a moderate economic recovery during second-half 1983. The decline in non-Communist oil consumption is expected to slow, and oil use is projected to exceed year-earlier levels by the fourth quarter. Although most forecasters expect the stock ajustment process to be completed this summer, they do not rule out a further decline in stocks, particularly if prices weaken. According to most of these forecasts, demand for OPEC crude oil will approximate 19-20 million b/d during second-half 1983, 2-3 million b/d above current levels (table 5). [redacted]

The size of a possible supply glut—the excess of desired production over demand for OPEC oil—provides an indication of the potential for downward price pressures. To estimate OPEC's desired production level, we calculated the level of production each country needed to maintain total financial assets at yearend 1982 levels, assuming current prices hold. On this basis, we estimate that OPEC's desired production approximates 23-24 million b/d including natural gas liquids, nearly 5 million b/d above our base line demand estimate. Should OPEC members attempt to achieve this desired production level, prices would be likely to fall sharply, perhaps to $20 per barrel or lower. [redacted]

Looking Ahead

The major factor behind OPEC's success in preventing a further drop in the price of oil these past few months has been the willingness of members to cooperate. Despite political differences in the Gulf, a major war between two members, and financial problems in some member countries, OPEC was able to reach an agreement on pricing and production that has basically been adhered to by all the participants: 25X1

- The Saudis accepted the role of swing producer and have been willing to bear the brunt of the decline in demand.
- Iran has largely abided by the production and pricing guidelines despite the ongoing war with Iraq and its political differences with other OPEC members in the Persian Gulf. 25X1
- Venezuela and Libya, two members that violated the 1982 OPEC accord, have adhered to the guidelines of the present pact.

OPEC has also been successful in attaining the apparent cooperation of such key non-OPEC producers as Mexico and the United Kingdom. [redacted] 25X1

Even though we believe this cooperation and a slight rise in oil demand will result in stable oil prices through the end of the year, oil exporters are by no means out of danger of a price collapse. Given the financial difficulties faced by many producers, a sustained rebound in oil consumption will be needed 25X1 to maintain cooperation and to avoid the temptation to cheat on pricing and production guidelines in an attempt to improve market share. Equally important will be the ability of OPEC members to establish new quotas once demand exceeds the present 17.5-million-b/d ceiling. We expect these negotiations to be difficult, and considerable pressure will be generated by several financially pressed members to obtain as large a share of the new quota as possible. The danger for OPEC would be to produce too much too soon, causing the accumulation of excess inventories and repeating the pattern of the past two years. If this were to happen, we would expect another crisis to develop early in 1984 when the market approaches the normal seasonal drop in oil consumption. [redacted] 25X1 25X1

OPEC's problems would be further compounded in the unlikely event that the Iran-Iraq war ends. Any attempt by Iran and Iraq to increase exports would put downward pressure on prices and force OPEC into difficult rationing decisions. While Iranian production is not constrained to its present level by the war, Iraq would require only four to six months after the war to increase exports by 1-2 million b/d. Even the anticipation of such an increase in supplies would soften the market and pose serious problems for producers attempting to maintain oil prices.

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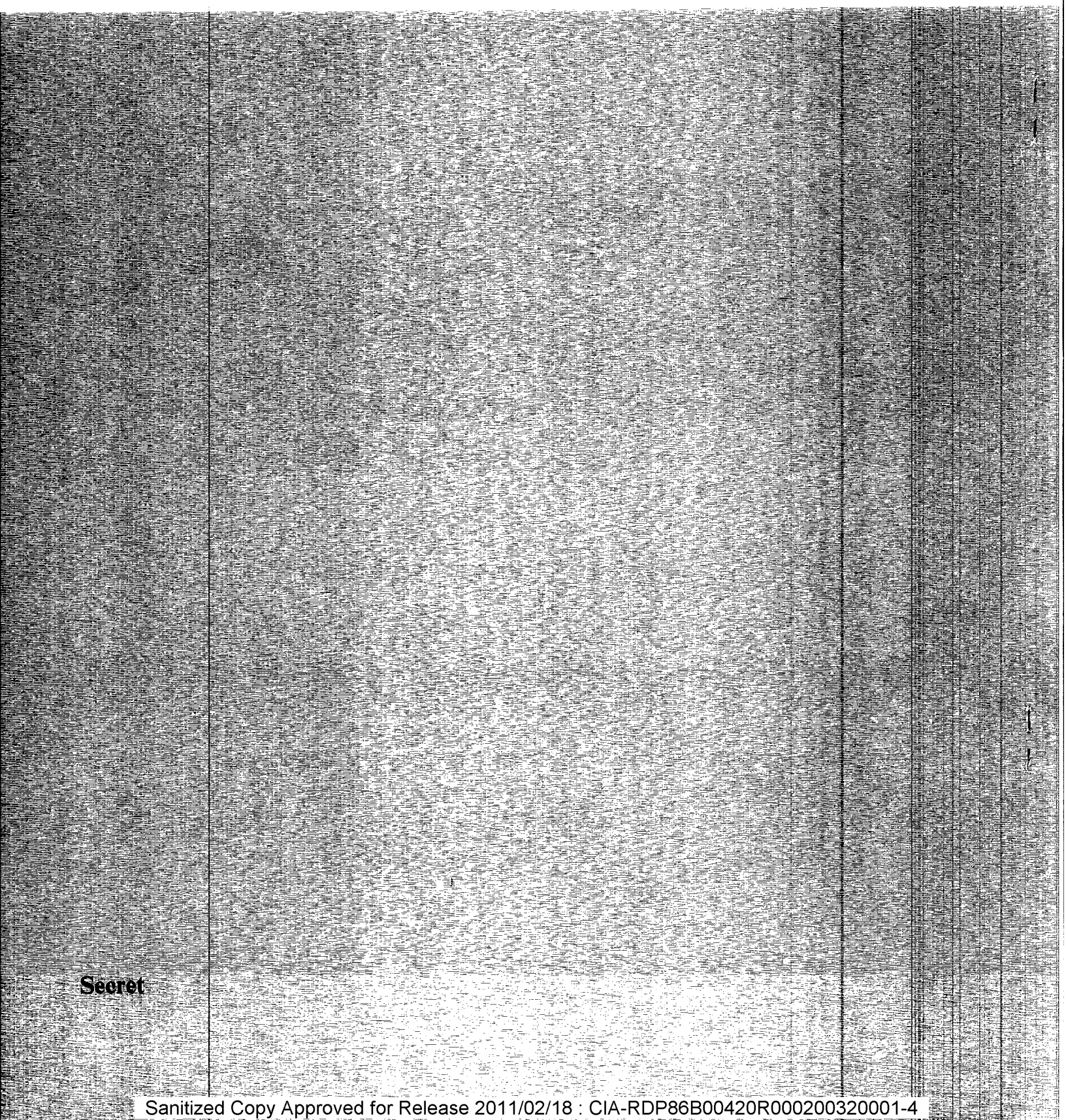

Briefs

Energy

Developed Countries' Dependence on Persian Gulf Supplies

The industrialized countries have cut oil consumption and imports particularly from the Persian Gulf region. Despite reductions in imports from the region—from nearly 15 million b/d in 1979 to approximately 6 million b/d last year—several industrialized countries rely on the Persian Gulf for more than one-third of their oil needs. [redacted] 25X1

Major Developed Countries: Estimated Dependence on Persian Gulf Oil Imports, January-September 1983

Thousand b/d

	Iran	Iraq	Kuwait	Qatar	Saudi Arabia	United Arab Emirates	Total Persian Gulf Oil	Total Developed Country Supply [a]	Persian Gulf Oil as a Share of Supply (*percent*)
Total	**1,282**	**407**	**363**	**208**	**2,716**	**948**	**5,924**	**36,627**	**16**
United States	59	10	9	NEGL	252	26	356	15,061	2
Japan	352	12	105	144	1,264	604	2,481	4,160	60
Canada	34	0	5	0	8	0	47	1,893	2
Western Europe	837	385	244	64	1,192	318	3,040	15,513	20
West Germany	47	26	27	6	145	30	281	2,290	12
France	88	25	19	20	294	128	574	1,860	31
Italy	229	111	90	10	227	66	733	1,880	39
United Kingdom	11	17	13	0	114	22	177	3,060	6
Austria	1	0	0	0	27	0	28	195	14
Belgium/ Luxembourg	8	37	1	3	38	0	87	723	12
Denmark	3	0	18	0	4	0	25	266	9
Finland	7	0	0	0	11	0	18	243	7
Greece	8	24	0	0	97	0	129	339	38
Netherlands	118	3	67	3	47	9	247	1,591	16
Norway	0	0	0	0	5	0	5	684	1
Portugal	25	19	0	0	49	7	100	208	48
Spain	163	45	0	22	99	54	383	1,096	35
Sweden	16	0	0	0	1	0	17	476	4
Switzerland	1	0	0	0	10	2	13	255	5
Turkey	112	78	9	0	24	0	223	347	64

[a] Production plus imports.

[redacted] 25X1

Non-Communist Oil Supply and Demand in 1984[a]

(million barrels per day)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Year
Total Consumption	46.5	43.2	43.5	46.0	44.8
Inventory Change	-2.4	0.1	1.4	-0.5	-0.3
Supply	44.1	43.3	44.9	45.5	44.5
of which					
Non-OPEC	24.9	24.7	25.0	25.3	25.0
OPEC	19.2	18.6	19.9	20.2	19.5

a Excludes refinery gain.

Non-Communist Primary Oil Stocks on Land-End of Quarter

	Million Barrels				Days of Forward Consumption			
	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
1983								
Commercial	3,565	3,540	3,720	3,580	84	83	80	78
Government-Owned	445	465	480	520	10	11	11	11
Total	4,010	4,005	4,200	4,100	94	94	91	89
1984								
Commercial	3,345	3,335	3,445	3,385	77	77	77	75
Government-Owned	540	560	575	595	11	12	13	12
Total	3,885	3,895	4,020	3,980	88	89	90	87