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REMARKS PREPARED FOR DELIVERY BY
THE HONORABLE FRANK G. ZARB, ADMINISTRATOR
THE FEDERAL ENERGY ADMINISTRATION, BEFORE THE

ROYAL INSTITUTE OF INTERNATIONAL AFFAIRS
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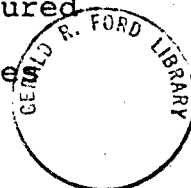
EMBARGOED FOR RELEASE UNTIL:
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Energy policy has been the subject of an intense national debate in the United States. The international dimension of U.S. energy policy is a central factor in our thinking. I would like this evening to share some thoughts on the international energy situation and the energy problems faced by the industrial nations.

The embargo and oil price increases of 1973 and 1974 caused great confusion and uncertainty in the United States and other industrial countries. Based on an overly optimistic evaluation of U.S. resources and the costs of developing them, the initial reaction of many Americans was to seek insulation from the threat by total self-reliance on energy. A goal was set of zero energy imports by 1980, the original concept of "Project Independence."

When the embargo ended without a total economic collapse in the industrial world, we had a chance to look at our energy problem with a more critical eye. An early task of the Federal Energy Administration was to examine in depth the meaning and implications of United States' energy self-sufficiency. We found the problem a difficult one. It was clear, however, that a policy of zero imports by 1980 or even by 1985 might well inflict more economic damage on the United States than the possible supply interruption the policy was designed to prevent. It was equally clear, however, that a continuation of existing trends in energy production and consumption would lead to an import dependence which could severely threaten the national security of the United States. This question of security quickly became central to our thinking on energy.

Prior to 1973, the security of energy supply was considered the responsibility of the private sector. The private international oil system consisted of numerous major oil companies which had developed over many years the capability to locate, produce, transport, refine and market the truly enormous amounts of energy demanded by the world. The private companies assured the industrial markets of the world a continuous supply of energy at low cost. Only a few observers foresaw the changes which were to take place.



In 1973, the governments of the oil-producing countries demonstrated that they were acquiring the expertise and the internal cohesion necessary to assert effective control over their industries. The changes in price and the distribution of profit were important, and we have all felt their effects.

The more basic and lasting change, however, was a change in the criteria by which petroleum decisions are made. Petroleum production, price and supply are now determined on the basis of the complex political, social and economic national aspirations of the petroleum producing countries.

The events of recent years have demonstrated the role played by Middle East politics in the international oil system. We can expect that economic and social development problems, internal and external politics will cause the petroleum policies of the producing countries to remain distinct and often opposed to the energy requirements of the industrial nations.

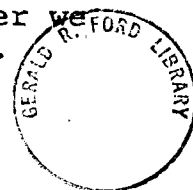
Energy supply security has thus become a basic concern of government in its domestic and foreign policies. This is not to say that governments had not been active before in the international petroleum system. The British and American Governments, as well as those of other industrial countries, played an important role in the history of the Middle East.

The interests of the private companies, however, were generally considered parallel although not identical to the interests of the consuming countries. The companies were thus relied on as the major actors in the system and served as a link between producer and consumer governments.

We can now expect the interests of the companies to become even more complex, as the companies strive to maintain their position in a system in which their assets and crude supplies are hostage to the producing states. In this sense, governments alone can define and assure supply security.

The new petroleum world in which we find ourselves has a number of unsettling features. A number of countries which should be classified as weak by traditional criteria seem able to make demand after demand which the industrial countries seem powerless to resist. Traditional relationships between industrial and underdeveloped countries no longer seem applicable.

It is vital that we come to understand the new international supply system and develop the proper approaches, programs and policies necessary to deal adequately with it. I cannot, of course, provide all the answers. I would like to present a few thoughts on the subject, however, and perhaps together we can obtain some insights into our common energy problems.



My first observation concerns the contrast between the current solidarity of the producing countries and the need to develop similar solidarity -- despite often diverse interests and resource endowments -- among the consuming countries. Any national or international energy program must be based on a clear understanding of the reasons for and solutions to this situation.

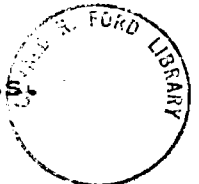
Many observers, including leading periodicals such as the Wall Street Journal, have argued vociferously that OPEC could not hold together as a producing organization. As world demand contracted, it was reasoned, competition for shrinking markets would force prices to the breaking point. In fact, OPEC has actually been able to raise prices by 10% for the fourth quarter of this year in the face of relatively low world demand. Increases in world demand with economic recovery may well strengthen OPEC's market position and ability to sustain and increase oil prices.

The remarkable success of OPEC is largely a result of the unique character of its membership. OPEC includes, on the one hand, countries with large populations and financial needs such as Nigeria, Indonesia and Algeria, and, on the other hand, countries such as Saudi Arabia, Kuwait and the United Arab Emirates with small populations and large financial surpluses. If we examine the distribution of petroleum production capacity and undeveloped petroleum resources, we find that by far the bulk of unused production and potential production lies in the countries of the Persian Gulf, the area of predominantly low population.

In other words, the countries with large revenue needs do not have the petroleum resources necessary to expand production substantially above current levels. OPEC is able to maintain its price because the countries which might be tempted to cheat on the cartel cannot do so, while the countries which are able to cheat have no incentive to do so.

At the very heart of OPEC is Saudi Arabia. Saudi Arabia currently possesses 23% of proven world petroleum reserves and 35% of proven OPEC reserves. Current OPEC production capacity is 37.5 million barrels per day, of which 10.8 or 29% is in Saudi Arabia.

The undeveloped resource potential in Saudi Arabia is so great that we can expect a continued increase in productive capacity over the next several years at least, to perhaps 15 or even 20 million barrels per day by the 1980's. Saudi Arabia may soon be in a position to offset production cuts or increases by any other combination of OPEC countries. The willingness of Saudi Arabia to set its price and allow production to vary with demand is crucial to OPEC's success.



Another element is the improved flexibility in OPEC's pricing system. During 1973 and 1974, OPEC raised oil prices through the agreement of its members to raise the various components of price, such as royalties, posted prices, taxes and government ownership, in unison. For example, in October 1973, posted prices, the prices used for tax reference, were raised to about \$5 per barrel. In December 1973, they were raised to about \$11. In June 1974, the royalty rate was raised from 12-1/2%, to 14-1/2%, and so on.

Since OPEC decisions did not adequately reflect market quality and transportation differentials, one result of this process was a change in the relative prices of oil from the various producing countries and loss by some countries of market share. It was difficult for a country to adjust its price without violating the rigid OPEC pricing formula.

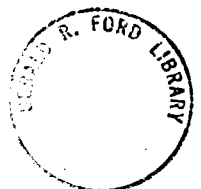
In December 1974, a new pricing system was instituted. The Government revenue to be derived from Arabian light crude is set each quarter. Each country then adopts a mixture of tax, royalty and other price policies at its own discretion to arrive at a comparable price which reflects geographic and quality differences.

This system allows more flexibility. A country can easily vary its price by 40 or 50 cents per barrel to assure its competitiveness. Price shaving is thus hidden in the complexity of the pricing structure. The market shares of the member countries are thus easily adjusted by shifting production cuts to the major Persian Gulf countries who are less concerned with production levels. OPEC has in fact instituted an automatic prorating system.

While the new international energy system has brought unprecedented financial and political successes to the OPEC countries, it has presented the consuming nations with a difficult set of problems.

The major industrial states have much in common. We share the need for secure and adequate supplies of energy, and we all have some degree of dependence on OPEC sources of petroleum, with Europe and Japan critically dependent upon Middle East sources.

There are, however, differences in our approaches to current energy problems which must be understood and taken into consideration as we work to strengthen the solidarity of the consumer group.



The clearest and most important difference is in energy resource endowment. The United States imports approximately 40% of petroleum requirements accounting for about 15% of total energy needs. We have vast resources of coal and shale and substantial amounts of conventional petroleum, uranium and other energy sources yet untapped. The United States is thus equipped to consider the concept of energy self-sufficiency as an option.

At the other extreme is Japan with negligible amounts of petroleum, natural gas, coal and uranium. Japan can vary its level of energy consumption and the structure of its import dependence, but must continue to rely on foreign sources for almost its entire energy supply.

Great Britain currently imports almost all of its petroleum requirements, but may in a few years be a net oil exporter when the North Sea is developed. The Netherlands has substantial reserves of natural gas, and so on.

The views of the consuming countries on energy conservation also vary. Each country has its own set of economic and social priorities, its own government regulatory philosophy, its own internal balance of energy sources, and its own environmental problems and views.

In short, each country has its own views on the meaning and costs of energy conservation. In the United States, for example, great attention has been paid to the automobile industry and the need to increase fuel economy. This problem is of an entirely different nature in Europe and Japan, where smaller cars have predominated for many years.

The consumer countries also show differences in foreign policy outlooks. For the United States, the politics of the Middle East and the central role of the United States in seeking a long-term settlement in that area have made the United States the focus of Arab hostility and the major target of the "oil weapon." This fact has been central to U.S. thinking on energy.

Some other industrial countries have less direct involvement in Middle East politics and thus may see little of importance to them in that area beyond energy. All consumers, however, are under continual pressure by some petroleum producing countries to adopt certain policy positions with regard to Israel and the Palestinians and all suffered the effects of the embargo and supply cutbacks of 1973 and 1974.



United States Middle East policy thus has a direct effect on the energy positions of all other consuming countries. The operation of the European Economic Community; Japanese relations with the U.S.S.R., the People's Republic of China and other Asian countries; the complex set of individual relationships between producer and consumer countries all contribute to the difference in national interest and outlook of the consuming countries.

It has been easy to assume that consumer solidarity is a simple matter. We all suffer from high prices, fear of production cutbacks and other problems resulting from producer government actions. A truly effective international effort by the consumer countries must be based on a detailed understanding of our differences, as well as our similarities.

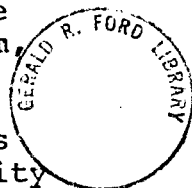
The establishment of the International Energy Agency in Paris represents an important step by key consumer countries to develop a cooperative approach to energy issues. Initiatives in, and support for, the programs of the I.E.A. are a key element of United States international energy policy.

The program of long-term cooperation now in the final stages of elaboration in the I.E.A. constitutes an essential step in our efforts to meet the energy challenge. This long-term program will establish a number of areas of important cooperation in the reduction of our overall dependence on imported oil through conservation and the development of new supplies. It will provide, moreover, a framework within which we can tie together and reinforce our national energy programs.

We also intend to play an active and constructive role in the producer/consumer dialogue now getting underway. U.S. initiatives in more general international groups, such as Secretary of State Kissinger's recent proposals in the United Nations Special Session, can be supportive of our international energy policy.

A major unifying element in the consumer country program must be an effective United States energy policy. The physical, technological, economic and political resources of the United States and the magnitude of U.S. energy consumption place the United States among the leaders of the industrial countries.

It has been clear to us from the beginning that if the United States cannot master its own energy problem or if the United States attempts to opt out of the world energy system, no effective consumer strategy may be possible. The most likely result of such a situation would be a headlong race by the major industrial countries to reach bilateral accords with oil producing countries. Such an unfortunate eventuality would not be conducive to international economic and political prosperity or even peace.



I realize that the leaders of other industrial countries have been following the U.S. debate on energy with some trepidation. It is vital, however, to understand the nature of that debate and to be aware of what has been decided and what remains to be decided.

In essence, the debate on energy in the United States centers on means rather than ends. Over the past year and a half, we have reached a broad consensus on the major aspects of the nature of the problem.

Most people in the United States realize the need to assure adequate and secure long-term supplies of energy. We understand the domestic potential of the United States and, perhaps most importantly, the international dimension of our energy situation.

We have yet to agree on the means to these ends, on the proper domestic pricing policy, the proper balance of private and public sector activity and other related questions.

In the United States, both the public sector and the private sector have undertaken massive research and investment programs to develop new and existing U.S. energy resources. The present decline in U.S. domestic energy production reflects not a lack of investment, but the long lead time -- on the order of 10 years -- required to bring new technologies and new production through existing technologies on-stream.

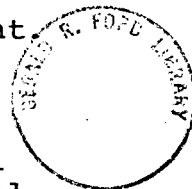
Our difficulty in defining our domestic production goals and their time horizons stems from constant escalation of cost and development time estimates for new U.S. energy sources. The programs continue in spite of these difficulties, and we expect substantial successes by 1985.

In addition to the development of U.S. resource potential and consumer country cooperation, an effective U.S. energy program must have two elements:

First, the stabilization of domestic pricing policy and the eventual removal of price controls from domestic petroleum are essential.

Secondly, the development of a strategic petroleum storage capability of up to one billion barrels must be undertaken. Such a capability would greatly improve the ability of the United States to resist the pressures of a supply curtailment.

I underline these particular features of U.S. energy policy to illustrate a point: Although the U.S. has far to go in developing national energy programs, the international dimension, and the views and requirements of other industrial consumer countries, are an integral part of our thinking and our actions on energy.



We can expect that the U.S. energy debate will generate a difficult series of compromise decisions. I can predict, however, that the energy decisions of the United States Government will reflect the need for an active American role in the international arena.

My remarks are not intended to imply that the development of effective consumer nation cooperation is an easy matter or that present and future U.S. energy programs will be sufficient for that end. There is now, however, a firm basis for that cooperation which must be encouraged. If each country can consider, define and articulate its own views on the security of energy supply, then we can jointly develop a real understanding of the new international energy system and of our divergent as well as common interests.

The evolution of the international petroleum system and the response of the industrial countries to it will exert a major influence on future trade in non-energy commodities. We are already seeing attempts by producers of bauxite, copper, iron ore and other commodities to form producer organizations on the OPEC model.

Although the success of OPEC is based on the unique features I outlined earlier, we can expect that the producers of other commodities will attempt to command higher prices through the restriction of production. Either on a general basis, or commodity-by-commodity, the consuming countries will have to respond to these challenges. In each case, the consuming countries will show a different set of common and divergent interests which must be managed. It is thus doubly important that we succeed in petroleum.

I hope that I have provided some insight into the nature of the new international energy system and the way it is viewed in the United States. I appreciate the opportunity to share my thoughts with you and would be most interested in hearing yours in reply.

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