The original documents are located in Box 33, folder "Transition Reports (1977) - Commerce Department: Consolidated Issues (2)" of the John Marsh Files at the Gerald R. Ford Presidential Library.

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MULTILATERAL TRADE NEGOTIATIONS

Background

Comprehensive Multilateral Trade Negotiations (MTN) were formally opened at the Tokyo Ministerial Meeting of September 1973. The Tokyo Declaration defined the scope and objectives of these negotiations in which some 100 countries are now participating in Geneva under the auspices of the General Agreement on Tariffs and Trade (GATT). Broad U.S. objectives and Presidential authority for the MTN are contained in the Trade Act of 1974. In February 1975, six negotiating groups were established to carry out the substantive work of the MTN: tariffs, nontariff measures, sectors, safeguards, agriculture, and tropical products. In November 1976, an additional group was established to explore possible improvements in the framework of the world trading system (GATT reform).

Issue

The issue is how best to ensure progress in the MTN toward the overall U.S. negotiating objective of obtaining, in both the industrial and agricultural sectors, greater and more equitable market access, and the harmonization, reduction or elimination of tariff and nontariff barriers which distort and limit trade. Commerce, as a key agency in the Executive Branch's trade policy decision-making apparatus -- coordinated by the White House Office of the Special Representative for Trade Negotiations (STR)--is particularly concerned that MTN results reflect the importance of industrial goods in U.S. trade. Progress in the MTN has been slow for economic and political reasons, but also due to the sheer number of participants and the magnitude and complexity of the subject matter. Important issues never before the focus of trade negotiation, notably those in the nontariff barrier area, are involved. Presently, three questions are especially critical to further progress in the MTN: agreement on a tariff reduction formula, resolution of the dispute over agriculture, and a framework for negotiations with developing countries. In addition, there is an overall question of the timeframe for the negotiations.

Analysis of Issue

The United States has been pursuing its negotiating objectives by taking an active role in all the MTN groups, and concentrating on resolving the critical questions mentioned above. In the area of tariffs, the U.S. has proposed a reduction formula producing significant overall reductions, with modest harmonization, of the duties of the major trading countries. However, other countries, especially the European Community and Japan, are far less interested in achieving substantial overall reductions than in harmonization (i.e., cuts concentrated in a limited number of high duties) and have, therefore, proposed their own formulas. If significant overall cuts are not achieved, many in the U.S. may view the MTN as a failure.

In almost every functional group, there is a procedural dispute over the treatment of agriculture. Essentially a U.S.-EC problem, the dispute centers on the EC desire to treat agricultural goods apart from industrial products and the U.S. insistence that agriculture and industry be treated together throughout the negotiations. Due to this disagreement, the negotiating group on agriculture has not met in nearly a year, and work in a number of other groups has been severely inhibited. To achieve future MTN progress, some accommodation with the EC must be reached.

The developing countries (LDCs) are playing a critical role in the MTN. Their principal objective--the achievement of special and differential (S&D) treatment for, and less than full reciprocity by, the LDCs, as mandated by the Tokyo Declaration--pervades every area of the negotiations. The U.S., along with the other developed countries, has attempted to convince the LDCs that multilateral trade liberalization on a most-favored-nation basis offers more secure benefits than discriminatory devices, and to encourage progressive LDC liberalization of their trade regimes through staged acceptance of the responsibilities and obligations of the international trading system ("graduation"). The ultimate resolution of this basic issue remains in doubt since many LDCs reject the U.S. approach, demanding a sweeping restructuring of existing international economic relationships based on the S&D concept.

Finally, with regard to timeframe, the United States has for some time advanced the idea that the MTN should be completed by the end of 1977 in order to give a sense of immediacy to the trade negotiations and to avoid a negotiating crisis just before the U.S. negotiating authority expires (end of 1979). This objective was reaffirmed at the June 1976 Puerto Rico summit meeting of the major industrialized countries. The U.S. is hopeful that the existence of a deadline will encourage greater progress, but mindful that the date is arbitrary and major differences among participating countries still remain. In addition, economic uncertainty in Europe, a slowdown in U.S. economic recovery, and the possible effects of further oil price increases may slow down progress in the MTN. The United States has floated the idea internationally of a Ministerial meeting in the spring of 1977 to provide further political impetus to the negotiations.

Schedule

With the change in the U.S. Administration and the membership of the EC Commission in January, there will be a need to take a fresh look at the status of the MTN. Commerce is preparing an overall strategy paper which, along with material prepared by STR, will have to be reviewed at the policy level by the new Administration so that the basic political decisions needed to make further progress in the MTN can be reached as soon as possible.

SPECIAL AND DIFFERENTIAL TREATMENT FOR DEVELOPING COUNTRIES

Background

Continuing efforts by less developed countries (LDCs) to restructure basic international economic relationships in a manner which will better promote their economic development form the basis for many of the trade issues confronting the U.S. and other developed countries (DCs). For a number of years LDCs have pursued their trade objectives not only in the forum of the General Agreement on Tariffs and Trade (GATT) but also in the meetings of the United Nations Conference on Trade and Development (UNCTAD). More recently, broad-ranging LDC proposals for reform of the international economic system have been made in other forums, including the UN General Assembly (UNGA) and the Conference on International Economic Cooperation (CIEC). The U.S. has sought to confine detailed consultation and negotiation on trade issues to the GATT and the current Multilateral Trade Negotiations (MTN) because of the technical nature of many of the issues, the more pragmatic nature of discussions, and the greater relative influence of the DCs in this forum. The Tokyo Declaration, which constitutes the basic MTN charter, emphasized the need to provide special and differential treatment for LDCs, a concept the U.S. supports when such treatment is feasible and appropriate.

Issue

Specific LDC proposals in the trade field center on special and differential treatment (S&D) to improve access for their exports of manufactured and semi-manufactured goods in the markets of DCs, although their proposals also cover other aspects of trade relations. While the U.S. and other DCs are on record as supporting the principle of S&D, U.S. acceptance of S&D has been coupled with emphasis on the need for LDCs to assume progressively greater obligations under the rules of the world trading system as their economies develop. Formulation of provisions to grant S&D, as agreed on by participants in the MTN, is an issue which runs throughout Commerce's MTN-related activities and raises basic questions about the traditional U.S. trade policy principles of reciprocity and most-favored-nation treatment.

Analysis of Issue

The U.S. faces the S&D issue in the context of the Tropical Products Negotiations, the ongoing work of the MTN groups (tariffs, subsidies/countervailing duties, standards, government procurement, safeguards, quantitative restrictions), and the newly constituted Framework Improvement Group.

In the Tropical Products Negotiations the U.S. is constrained by the Trade Act and commitments to the business community not to grant unreciprocated concessions to the LDCs participating in the negotiations. Consequently, we are seeking contributions from LDC participants prior to conclusion of the negotiations. If the U.S. accords S&D treatment through implementation of concessions now without LDC commitments for some degree of reciprocity, we could be placed in the position at the conclusion of the MTN of obtaining little or nothing in terms of meaningful LDC concessions and with a negotiated package which is unacceptable to both the Congress and U.S. business.

Negotiations on the topics under consideration in the other MTN groups are less advanced. Particularly in interagency development of positions, various possibilities for S&D are being explored, and the U.S. has made some suggestions in the negotiating groups. Throughout its consideration of possible S&D measures, the U.S. Government has regarded such measures as a temporary exception to the normal rules and has sought means of ending S&D as the economies of LDCs develop (termed the "graduation" concept).

In developing appropriate terms of reference for a group to consider means of improving the international trading framework, the establishment of which has stemmed from strong LDC initiatives, the U.S. in discussions with both DCs and LDCs worked for inclusion of the graduation concept. Under its terms of reference, the group is to seek to negotiate improvements in the international framework for the conduct of world trade, particularly with respect to trade between developed and developing countries, and differential and more favorable treatment to be adopted in such trade.

In the Framework Improvement Group the U.S. will be confronted directly with the necessity of considering its traditional commitments to the principle of reciprocity and also to the most-favored-nation principle in the context of trade relations with LDCs. Accommodation to LDC positions implies movement by the U.S. away from its traditional principles and requires close consultation with both the Congress and the private sector. Development of the concept of graduation, including how it might be implemented and negotiated, is likely to be an essential element in gaining acceptance of changes in traditional U.S. trade policy to benefit LDCs.

Schedule

The crunch on S&D provisions will probably come earlier in the case of the Tropical Products Negotiations than in the other areas. Specifically, timing of the implementation of concessions in the Tropical Products Negotiations is a current issue. Other DCs have indicated their willingness to implement most of their concessions (consisting primarily of GSP improvements) unilaterally January 1, 1977 or soon thereafter; the U.S. position continues to be to seek contributions from the LDCs prior to implementation of the U.S. offers which would encompass MFN tariff reductions. In an attempt to overcome the present impasse, interagency agreement has been given to consideration of possible provisional implementation, i.e., implementation of U.S. concessions with the understanding that adequate LDC contributions will be forthcoming at the end of the MTN or U.S. concessions will be withdrawn. The MTN Delegation has been instructed to employ this option only if our negotiators believe it would substantially improve the chances for meaningful progress. The U.S. will come under increased pressure to modify its position early in 1977.

PROTECTION OF U.S. FOREIGN INVESTMENTS

A. UN Code of Conduct on Transnational Corporations

Background

UN involvement in issues relating to transnational corporations (TNCs) -- the UN term for multinational corporations -- originated with Chile's complaint in 1972 over the alleged interference by ITT in its internal affairs. As a result, the UN Secretary-General, at the request of the Economic and Social Council (ECOSOC), appointed a group of 20 Eminent Persons from developed and developing countries to examine the impact of TNCs on world development and international relations. The recommendations of the group, which included two U.S. representatives, led to the formation within the UN of a Commission on Transnational Corporations (UNTNC) and a subordinate body, the Information and Research Center on TNCs. The Eminent Persons Report proposed an elaborate, legally binding code of behavior. To date the Commission has met twice and has agreed to an elaborate work program involving extensive information gathering and also agreed, as a first priority, to complete a draft code of behavior by the end of 1977. An Intergovernmental Working Group (on which Commerce expects to be represented) is scheduled to meet in New York in January and February 1977 to begin to prepare an annotated outline of a code.

Issue

The main issue is whether the code recognizes and incorporates the following principles which we and other OECD countries regard as basic. Essentially the U.S. and most developed countries insist that a UN code conform to the following principles: that the code be voluntary, nondiscriminatory, recognize existing international law, place obligations and responsibilities on both companies and governments, provide for international arbitration in settling investment disputes, and, in cases of nationalization of foreign-owned property, provide for prompt, adequate and effective compensation. A number of these principles are not accepted by developing countries, although they are contained in the OECD code and associated documents which were accepted by 24 OECD members in Paris in June 1976. Resolution of these differences is essential if a UN code is to be accepted.

Analysis of Issue

No special analyses are underway at present since an annotated outline is still to be developed by the UNTNC and none is expected much before the January 1977 meeting. The extent of possible compromise will depend on how negotiations develop. Our starting position is the principles contained in the OECD code which developed countries generally accept. There is a good deal of doubt whether a workable compromise is possible. On the issue of a voluntary versus a binding code, we will not compromise, and at the present time the developing countries want a binding code.

Schedule

In addition to the January 1977 meeting, another meeting is scheduled in New York between April 25-May 6, 1977. Subsequent meetings will be scheduled as necessary. Although a target date at the end of 1977 is scheduled for completing a draft, few countries regard this as feasible. It is widely expected that discussions will continue into 1978.

B. UN Code of Conduct on Transfer of Technology

Background

In September 1975 the UN General Assembly adopted a resolution calling on all states to formulate a code of conduct for the transfer of technology to assist the special needs of developing countries. The resolution specified that such work be conducted in the United Nations Conference on Trade and Development (UNCTAD) and recommended that a draft code be completed by mid-1977 with a final draft for adoption by the end of 1977. To carry the work forward, an intergovernmental group of experts was established to elaborate a draft. The group of experts held several meetings in 1975-76 and are scheduled to hold three more meetings in 1977. As a result of these negotiations two draft proposals were produced, one submitted by Group B (the U.S. and other developed countries) and another by the Group of 77 (the developing countries). The documents revealed a wide gap in the two positions on several key points and no drafting was attempted pending the outcome of UNCTAD IV. This conference, which was held in Nairobi in May 1976, hoped to adopt a resolution which would resolve the legal character of the code, i.e., whether it was to be voluntary or legally binding and to establish terms of reference for actual drafting and adoption. Agreement was not achieved, and the nature of the code was not resolved because Group B and the Group of 77 each were intransigent in maintaining their respective positions. The final resolution skirted this issue and recommended that work on the code go forward with a goal to complete a draft by mid-1977; that provisions be formulated ranging from mandatory to optional without prejudice to final action on the legal character of the code; and that the UN General Assembly convene a conference at the end of 1977 at which all decisions on adoption of the code, including its legal character, would be made. An expert group met in Geneva from November 8-19 to continue further its work on the code.

Issue

The basic issue concerning the code is whether it is voluntary or legally binding. There is also disagreement on other basic issues, including recognition that the guidelines must recognize the validity of international law and treaties; that responsibilities for implementation of the guidelines apply to both parties; that the guidelines outline responsibilities of enterprises and governments; that access to technology be based on mutually-agreed terms and conditions, including price; that restrictive business practices be avoided; and that parties to a technology transfer agreement have free recourse to international arbitration in cases of disputes. The developing countries view access to technology as a universal right, stress primacy of domestic law, are less concerned with confidentiality of technology transfers and do not favor international disputes settlement.

Analysis of Issue

The degree of flexibility and compromise depends on whether the code is to be voluntary or not and Group B will insist on this point, arguing it would be seriously inhibited in its ability to draft a code without having in mind the premise on which it is proceeding. At this stage, however, only procedures for drafting are being considered and thus no attempt to stake out firm positions has been undertaken. Moreover, given the highly technical and complex nature of the document the basic position of Group B countries is contained in its draft proposal and there is no need to go beyond this statement at this time. In addition we will seek the advice of the State Department's Advisory Committee on Transnational Enterprises which was consulted on the OECD code as negotiations proceeded.

Schedule

Three more meetings are scheduled in 1977 but it is doubtful that an agreed draft can be completed for consideration by the end of 1977.

FOREIGN EXPROPRIATION OF U.S. ASSETS ABROAD

Background

In the last decade developing countries became increasingly aggressive in seeking solutions to their problems of slow per capita economic growth. This has often led to expropriation of private foreign investment. The USG believes such a seizure of private property leads to an environment that is not conducive to the flow of capital and technology essential to economic development. Nevertheless, the USG recognizes the rights of sovereign states to nationalize or expropriate foreign-owned property so long as any taking conforms with international law which requires the takings to be 1) non-discriminatory; 2) for a public purpose; and 3) accompanied by prompt, adequate, and effective compensation.

Numerous U.S. laws impose sanctions against countries which expropriate property owned by U.S. citizens are not taking steps to compensate the former owners. The major laws are the Hickenlooper Amendment to the Foreign Assistance Act withholding aid if expropriated property is not paid for or steps taken to insure payment; the Gonzalez Amendment to legislation involving the InterAmerican Development Bank, Asian Development Bank, and World Bank and requiring the U.S. to withhold support for loans; and Section 502 (b) (4) of the Trade Act of 1974 requiring the withholding of trade preferences.

The CIEP Interagency Staff Coordinating Group on Expropriation meets every 4-6 weeks to review countries' progress in resolving outstanding expropriation cases. The Group has been concerned that expropriation remains a serious problem and has noted that several recent nationalizations have involved entire economic sectors. The Treasury Department has also charged that the Group is not applying the law "fearlessly" and even-handedly and believes present policy fails to focus adequately on broad U.S. economic (rather than political) interests affected by expropriation and does not sufficiently stress deterrence.

The CIEP Group is therefore, reviewing USG expropriation policy with a view toward deterring expropriations, limiting their scope, and contributing to fairer settlements. An Economic Policy Board decision of July 15, 1976 further directed the CIEP group to 1) identify and analyze USG economic interests affected by actual or potential expropriation disputes in potash, bauxite, etc., 2) examine possible changes or improvements in policies or operations to assure that the USG economic interests are adequately taken into account, including improving the existing "early warning system" and better coordination of key policy decisions; 3) formulate recommended guidelines to enable the USG to more effectively protect its own economic and other interests in particular cases; and 4) explore possible multilateral actions which might be taken to further U.S. and other investing country interests in expropriation cases.

Issue

The main issue is whether the existing machinery and procedures for dealing with expropriation cases is adequate or whether changes along the lines proposed by Treasury should be introduced.

Analysis of Issue

In regard to the EPB directives, several drafts have been reviewed by the CIEP members that discuss either U.S. interests in the bauxite and potash expropriation disputes or proposed guidelines for evaluating progress in the settlement of expropriations. Commerce has supported development of guidelines for the evaluation of progress as long as the guidelines were reference points and not inflexible criteria which, when not met, required specific responses. A number of steps have already been taken to implement other approaches to increase U.S. expropriation policy effectiveness including seeking to negotiate: 1) a judicial remedies convention to provide a better basis for bringing suit against expropriated property; and 2) a multilateral investment insurance scheme which would also be consistent with the proposal for an international resources bank.

Other procedures suggested to help deter further expropriations are to 1) include guidelines in international MNC codes of conduct setting forth general conditions under which multinational enterprises should be able to operate and 2) negotiate additional Friendship, Commerce, and Navigation (FCN) treaties with interested countries.

Commerce has consistently favored increased information sharing, developing greater awareness among Foreign Service Post staffs of the importance of investment matters, and the use, on a limited basis, of contractors for valuation of expropriated properties. We also believe the USG should develop a more timely response to, and active participation in, resolving significant disputes before they reach the stage of high level confrontation where flexibility among the parties involved is difficult to obtain. Nevertheless, we realize that expropriatory acts must be considered in the larger context that encompasses the entire economic/political relationship between the United States and the country in question and takes into consideration other investments U.S. citizens may have in that country. Furthermore, discussions with business have repeatedly shown that companies themselves often do not favor USG involvement in business disputes because they feel that such intervention raises to the political level a dispute that may not have political overtones in itself and tends to harden positions making resolution more difficult. Commerce continues to favor international agreements, such as codes of conduct, a multilateral insurance scheme, and a judicial remedies convention as reasonable and effective methods to increase investor protection.

A Treasury proposal for the establishment of a Special Representative for Overseas Investment within Treasury with the objective of preventing expropriatory acts was rejected by the CIEP Group because of concern that it would result in a less flexible and balanced expropriation policy without increasing its effectiveness. The recent success of a high level U.S. negotiating team in resolving the expropriation by Peru of the Marcona Mining Co. supports the Group's position that the current framework is sufficiently flexible to allow USG response to be fit to the situation.

Schedule

Papers on bauxite and potash with recommendations for USG action, if any, should be completed in the 1st quarter of CY 1977, as should any guidelines which may be approved by the group.

An investment insurance program and a judicial remedies convention will involve negotiations over several years.

Development of international codes of conduct is an ongoing process, with the UN currently in the initial stages of its code development. The OECD just concluded agreement on its code. FCN treaties would be signed over the next 10-20 years.

FOREIGN INVESTMENT IN THE U.S.

Background

The acceleration and changing complexion of foreign direct investment in the United States has produced some public concern and the introduction of various restrictive bills in Congress, all unsuccessful. The Administration has opposed these bills, reaffirming its open-door, non-discriminatory policy; but it has set up monitoring and special case consultative procedures involving Commerce. Commerce and Treasury have sent extensive reports to Congress which provide underpinning for current policy. Nevertheless, more restrictive bills are expected and specific investment transactions may offer problems.

Issue

Ensure that existing U.S. policies, laws, regulations and administrative programs in regard to foreign investment in the United States are sufficient to serve the national interest.

Analysis of Issue

The traditional open-door, non-discriminatory policy toward foreign investment in the United States has been questioned in light of its recent accelerated growth, the emergence of new investor countries -- particularly Japan and the Middle East OPEC countries --, takeover efforts by foreign firms, and concern over increased foreign interest in acquiring agricultural land and other natural resources. Foreign investors are subjected to limited restraints regarding communications, transportation, banking, energy, and publicly-owned land, and to Defense Department clearances respecting acquisition of U.S. firms performing on defense contracts.

The various bills in the Congress which would screen, regulate, and restrict foreign investments have been consistently opposed by the Administration as unjustified by foreign investment developments. However, it conceded that information on foreign investment was insufficient and supported the passage of the Foreign Investment Study Act of 1974 which required Commerce and Treasury to conduct extensive studies and submit reports to Congress on direct and portfolio investments in the United States respectively.

The Commerce nine-volume, 2,500 page report submitted to Congress in June 1976 found no basis in the motivation, composition, magnitude, conduct, or economic effects of foreign direct investments to warrant any change in the existing policy, but it recommended legislation strengthening data gathering authority and the continuation of monitoring and analytical activity. It found current policies, laws, regulations and procedures adequate to deal with current and foreseeable inward foreign investment developments.

In mid-1975, after a full-scale Executive Branch policy review and in recognition of a need for mechanisms to become better informed on a current basis on inward foreign investment activity and to be able to deal with investments having national interest implications, the President, while reaffirming existing policy, issued an Executive Order establishing an interagency Committee on Foreign Investment in the United States with policy coordination and special case review responsibilities. It also provided for the establishment of a monitoring, analysis, and reporting facility in Commerce.

The Committee, chaired by Treasury and with Commerce representation, has focused on foreign government investments, and in the few cases considered has found no basis for intervention on national interest grounds. Foreign governments have been asked to consult on their intended investments. The Committee has no special legal power to prohibit specific investments, but prospective investors are unlikely to proceed in the face of an adverse reaction by the United States Government. Commerce has implemented its monitoring responsibility through the establishment of the Office of Foreign Investment in the United States, which has undertaken a broad-scale data gathering, analysis and reporting program.

In October 1976, the President signed the International Investment Survey Act of 1976, introduced by Senator Inouye and supported by the Administration. The Act provides the President broad authority to collect data on both inward and outward foreign direct and portfolio investment; it further requires benchmark statistical surveys every 5 years, the preparation of statistical and analytical studies, and the provision of reports to Congress. An Executive Order assigning responsibility to Commerce, Treasury and other agencies is in preparation.

It is anticipated that public concern about inward foreign investments will continue to be manifested in restrictive bills in Congress. Specific investment transactions, such as OPEC country investments in U.S. petroleum production, could require searching examination of the implications for the national interest. It is recommended that restrictive legislation continue to be opposed, but that Commerce have a flexible position on specific cases brought before the Committee on Foreign Investment in the United States.

Schedule

This issue is a continuing one. Commerce's Office of Foreign Investment in the United States plans publication of industry sector and economic impact analyses respecting foreign direct investments throughout the year.

DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)
AND FOREIGN EXPORT TAX INCENTIVES

Background

The Domestic International Sales Corporation (DISC) provisions of the tax code allow U.S. exporters to defer the imposition of Federal Income taxes on basically one-half of their export profits by forming special corporations called DISCs. This tax incentive was designed to give U.S. exporters some of the tax advantages enjoyed (1) by foreign exporters through the tax incentives and rebates provided by their governments, and (2) by U.S. multinational companies due to the fact that the earnings of their foreign subsidiaries are generally insulated from U.S. taxes until repatriated. By correcting this imbalance, it was hoped that U.S. exports would increase and our balance of trade would improve.

As of October 1, 1976, there were 9,090 DISCs, and about 75 percent of U.S. export sales were accomplished through DISCs in 1976. Estimates made by the Department of the Treasury, based on its April 1976 report to Congress on the DISC, indicate that in 1976 this incentive will have increased exports more than $8 billion at a cost of approximately $1 billion in deferred tax revenue.

Because of concern in Congress and elsewhere about the current revenue loss attributed to the DISC, which is higher than anticipated when the law was passed, this benefit has been somewhat curtailed in both the Tax Reduction Act of 1975 and the Tax Reform Act of 1976.

In 1973, the European Community, supported by Canada, instigated a formal complaint under the General Agreement on Tariffs and Trade (GATT) against the DISC, charging that the DISC is a prohibited export subsidy violating GATT rules. As a countermove, the United States made similar charges against tax provisions in France, Belgium and the Netherlands which are designed to reduce or eliminate taxes on the export earnings of their firms. Each country concerned staunchly defended its practices as consistent with GATT rules. On November 2, 1976, GATT panels ruled that elements of all four of the tax practices in question are illegal under the GATT.

Issue

Should the DISC be: (1) maintained as is; (2) curtailed to reduce further its revenue loss to the Treasury; (3) repealed or modified unilaterally; (4) repealed or modified as part of a negotiation with other governments to eliminate tax schemes which directly or indirectly subsidize exports.

Analysis of Issue

Unless France, Belgium and the Netherlands act concurrently with the United States to abide by the recent GATT decision, it is unlikely that the support for the DISC in Congress will be seriously affected. Although the opponents of the DISC will have the argument that parts of it have now been found to be illegal under the GATT, many Congressmen will not want to repeal the DISC unilaterally, because it would obviously discriminate against U.S. exporters vis-a-vis foreign exporters. Further, the chief argument of the DISC opponents, that the DISC is ineffective, has been implicitly refuted by the GATT decision. Accordingly, the problem is to see if the DISC can be used as a "bargaining chip" in negotiations to eliminate comparable tax benefits for exporters worldwide, or at least with respect to the four countries involved in the current GATT decision.

However, unilateral and timely dismantling or modification of the DISC program offers the advantage of avoiding retaliation by other countries for our use of an illegal practice. Canada, for one, seems likely to seek some form of retaliation or compensation. We cannot yet be certain, however, that the European practices will be removed and ending the DISC without an end to the European practices seems likely to prompt loud criticism from U.S. industry. Accordingly, consultations will be arranged with the Europeans to discuss ending our respective practices.

There is a larger question however. Many countries seem to have practices similar to those that have been declared illegal. (We understand that the Treasury Department is attempting to catalog these.) Removal of the DISC, with or without removal of the French, Belgian or Dutch practices, would place U.S. exporters at a disadvantage with respect to exporters of countries using similar practices. This problem has already been referred to by all four countries in GATT meetings. The United States has also suggested that a broader GATT examination is needed of the trade effects of national income tax practices, possibly leading to new or clearer international rules.

Schedule

Consultations are likely to be held with the Europeans in December or early in 1977 to discuss removal or modification of our respective tax practices. We are also likely to propose early in 1977 an examination of the trade impact of national income tax practices.

Further review of DISC cost effectiveness will be possible after Treasury's next report to the Congress becomes available on April 15, 1977.

EXPORT FINANCING

Background

Since 1934, the Export-Import Bank, an independent Government agency, has been engaged in financing U.S. exports. For short and medium repayment terms of up to five years, Eximbank guarantees and insurance promote the extension of private export credit by eliminating most of the risks of default. In the long-term area, Eximbank provides its own direct loans to alleviate a deficiency in the supply of private credit which otherwise would impede the sale abroad, particularly in LDC's, of high-value capital equipment items warranting extended repayment terms. Eximbank direct loans also provide some assistance to U.S. exporters in competing against foreign suppliers who are liberally financed by their own governments. Finally, under its discount loan program, Eximbank offers a liquidity incentive to the private sector to extend export loans by commiting itself to refinance such loans in time of need.

Recent authorization levels are as follows (in billions of dollars):

	FY-76	FY-75	FY-74	FY-73	FY-72
Total Authorizations	$8.6	$8.3	$9.1	$8.5	$7.2
Long-term Finance	3.1	3.6	4.9	3.8	3.4
Direct Loans	2.1	2.5	3.8	2.3	2.2
Related Financial Guarantees	1.0	1.1	1.1	1.5	1.2
Short- and Medium-term Finance	5.7	4.6	4.2	4.7	3.9
Regular Bank Guarantees	0.6	0.4	0.4	0.5	0.5
Insurance	3.5	2.9	2.6	2.5	2.2
Discount Loans	1.2	1.1	0.9	1.6	1.0
CFF Loans	0.2	0.2	0.3	0.1	0.1

Eximbank operations do not depend on formal Congressional appropriations. Rather, Eximbank obtains the funds needed for its net loan disbursements principally by borrowing on the private financial markets via the U.S. Treasury. (The guarantee and insurance programs entail no, or negligible, net expenditures.)

Eximbank's direct loan program tends to be market-related. The cost of Eximbank borrowing and the Bank's long-run objective of earning a profit are major determinants of the interest rate charged on its direct loans: presently, 8.25 percent for 6-year loans guaduating upward to 9.5 percent for 14-year loans. Furthermore, Eximbank requires that its loans not exceed 30 to 45 percent, typically, of the value of the U.S. export involved, with the remainder covered by a cash downpayment and by commercial bank financing at floating market rates. The private participation may be protected by an Eximbank financial guarantee, if necessary. On the other hand, some foreign countries provide their exporters with credit that is basically insulated from money market conditions.

Issue

To ensure the adequacy and competitiveness of the U.S. export financing system (Eximbank, FCIA, commercial banks, etc.)

Analysis of Issue

In recent months we have heard expressions of concern from the business community that Eximbank was not providing maximum support and encouragement for U.S. exports. At the request of the President's Export Council, Commerce is contracting for an independent appraisal of the U.S. export credit system. The U.S. Chamber of Commerce, the Machinery and Allied products Institute, and perhaps some other groups, are also understood to be studying the adequacy and competitiveness of Eximbank financing. The major concern appears to be with Eximbank's long-term credit support for capital goods exports, activity in which appears to have declined in the past fiscal year (see above table.)

The issue lacks precise definition as it presently stands. The recent Eximbank management which took office in January 1976 tended to maximize private lending and to limit the Bank's own involvement to the minimum necessary to offset shortfalls in maturities, risk inhibitions, and foreign credit competition. It also changed numerous program details, such as new restrictions on aircraft loans, a more cautious attitude on lending to certain LDC's, and new constraints on financing exports to foreign subsidiaries of U.S. corporate parents. Each one of these changes could be unobjectionable if taken in isolation, but collectively they may have made Eximbank a more conservative institution generally.

Currently, however, any deficiency in Eximbank's responsiveness appears to be partly offset by an ample supply of lendable funds at cheap interest rates at commercial banks. The problem may become more critical if monetary conditions should tighten. Moreover, U.S. exporters using Eximbank financial packages may be at an interest rate disadvantage vis-a-vis foreign competitors if Eximbank's market-related rates are not compensated for by flexibility in other credit dimensions.

The Treasury has welcomed these program changes at Eximbank and views them as consistent with a floating exchange rate regime minimally affected by special balance of payments measures. A reduced Eximbank direct lending program also accords with Treasury's general desire to restrain Government borrowing on the private capital markets.

Schedule

1st Quarter 1977: A new Eximbank management will be appointed.

2nd Quarter 1977: The Commerce and other studies of Eximbank financing should be completed.

3rd Quarter 1977: Congressional hearings on the renewal of Eximbank's charter legislation should commence. Commerce and business groups will have an opportunity to express their views on Eximbank's future orientation and to suggest changes in the legislative mandate as needed.

U.S. TAX TREATMENT OF FOREIGN INCOME

Background

The United States taxes the worldwide income of U.S. citizens and corporations. However, for foreign source income this treatment is generally mitigated by the provision of (1) a dollar-for-dollar tax credit for foreign taxes paid, (2) deferral of taxation on the unrepatriated earnings of U.S. owned foreign corporations and (3) a limited exemption from U.S. taxation of the earned income of U.S. individuals living abroad. All of these mitigating provisions have been questioned in Congress and elsewhere over the past several years, mainly on the ground that they encourage U.S. companies to make investments and conduct operations abroad and thus "export jobs" from the United States. As a result, the Tax Reduction Act of 1975 and the Tax Reform Act of 1976 have circumscribed more tightly the foreign credit and deferral mechanisms, and the latter legislation erased part of the earned income exemption for individuals. It is expected that during the course of the 95th Congress efforts will again be made to further limit or eliminate the tax credit or deferral benefits for U.S. multinational corporations, and perhaps to restore some of the earned income exemption benefits lost by the 1976 act.

In addition, regulations promulgated by the IRS on various features of the tax code which affect the taxation of foreign source income occasionally are either too stringent or less helpful than they need to be to enforce the provisions of the tax code to which they relate. This has been particularily true of IRS Regulation 1.861-8, first proposed in June 1973. It treats in detail the allocation of deductions U.S. multinational corporations can claim in computing taxable income from business operations within and without the U.S. The regulation as originally proposed would require many U.S. multinationals to transfer deductions from domestic to foreign operations, reducing their foreign taxable income and increasing U.S. source income. Its immediate consequence will be to increase significantly the overall taxes paid by these corporations. Accordingly, economic double taxation of U.S. multinationals will inevitably occur. Particularly hard hit would be U.S. multinationals which have large expenses for R&D, and some have indicated that this regulation would compel them to move their research establishments out of the U.S.

Because Commerce Secretaries Dent and Morton, the business community and other Federal agencies expressed concern on the R&D impact of this proposed regulation, the Economic Policy Board was given the task of studying the question and, if necessary, coming up with alternative proposals. In June 1976 the Commerce Department supplied the EPB with a study which surveyed 76 R&D intensive multinational companies on what the proposed regulations would do to impel them to reduce their R&D establishments in the U.S. or move them out of the U.S. As a result the Treasury and IRS came up with a compromise on November 8, and IRS issued a new 1.861-8 proposal regulation, which mitigates somewhat the tax burden the 1973 version would have imposed on U.S. multinationals because of allocations abroad of R&D and interest expense. Public comment on this new proposal is due by December 7, 1976 and hearings are to commence on December 16, 1976.

Issue

(1) Should the Department initiate, support or oppose the variety of suggestions that will be broached in Congress and possibly within the Administration to change or eliminate the foreign tax credit, the opportunity to defer U.S. taxes on the unrepatriated income of U.S. held foreign affiliates, and the earned income exception for U.S. taxpayers living abroad.

(2) If not approved by the EPB and made final in January of 1977, should Commerce recommend to the EPB that the IRS November 8 compromise proposal on the 1.861-8 regulation be (1) made final, (2) studied further, (3) modified further, or (4) scrapped in favor of making the 1973 proposal final.

Analysis of Issues

(1) Inasmuch as any proposals to change the tax code in terms of its treatment of foreign source income are likely to come from outside the Department of Commerce, their nature is not yet known and precise issues have not been defined. However, it is incumbent upon the Commerce Department to analyze such proposals when it is called upon for comment by Congress or the Administration, and perhaps to initiate new tax legislation when a strong and justified need therefor is expressed by the business community.

(2) Commerce has not yet had time to assess the impact the new proposed regulation 1.861-8 will have on the continued ability and inclination of the U.S. multinationals to keep a strong R&D establishment based in the United States. However, the industry and other public comment expected to be filed with the IRS by December 7 and the public hearings to commence on December 16 should put the Department in a position to make at least a tentative analysis and recommendation to the EPB on this important matter. It may be that the impact of a new proposal will not be sufficiently clear for a definite decision to be made on the possible alternatives until a further survey of affected companies (and a study of that survey) is made. Accordingly, if no final decision is made before the end of January 1977, the new Administration may have to review the problem and decide what to do about IRS efforts to write a regulation on section 861 allocations.

Schedule

(1) Nothing Scheduled

(2) -- Receipt in early December of analysis of hypothetical effect new 1.861-8 proposal will have on R&D-intensive multinationals, i.e., whether they will use gross-to-gross alternative or sales alternative to lighten the tax burden. This analysis will be made by Mr. Roy Blough, under contract with the Department.

-- Receipt of synopsis and critique of public and industry comments due to be filed with the IRS by December 7. This synopsis and critique is also being done by Mr. Roy Blough for the Treasury Department.

-- Attendance at the IRS hearings scheduled to commence on December 16th.

-- After the hearings are over preparation of Commerce Department recommendation on the compromise 1.861-8 proposal. This is to be submitted to EPB task force on international taxation, for consideration at a meeting scheduled to be held after hearings, but before January 1, 1977.

TRADE PRACTICES OF THE EUROPEAN COMMUNITY

Background

Collectively, the European Community (EC) is the largest foreign market for the United States and our second largest supplier. It accounts for one-fifth of our total trade. Further, at the end of 1975 U.S. private direct investment in the EC was valued at $39 billion, nearly one-third of our direct investment worldwide. In view of the magnitude of this economic relationship, our commercial interests are often affected by trade and other policies of the EC itself or its member states.

For example, the EC recently altered the application of its commitments under the Florence Agreement covering trade in scientific instruments for scientific and educational purposes so as to afford increased protection to its domestic industry. When the EC expanded its membership to include the U.K., Ireland and Denmark, it entered into free trade agreements with the seven remaining EFTA countries which included highly restrictive origin rules. These rules limit the amount of third-party content that can be included in a product if it is to qualify for preferential treatment.

Three EC member states currently maintain programs to insure exporters against increases in their production costs in export contracts. These programs distort trade and in the U.S. view are export subsidies not sanctioned by the GATT. The EC maintains a vast network of preferential trade arrangements with Mediterranean countries and developing countries, particularly in Africa, which are inherently discriminatory. Within the EC such major countries as Italy and the U.K. confront trade deficits, currency pressure, and loss of international monetary reserves and have introduced or may impose restrictions on their imports. It is in the U.S. interest to develop ways to reduce the restrictive impact of these various measures which have grown out of the EC's customs union or which have been taken for balance of payments reasons.

Issue

Prevent the adoption of, or obtain modification of, those trade practices of the European Community and its member states which distort U.S. trade and investment.

Analysis of Issue

The Department should where necessary defend the rights of U.S. businessmen--both traders and investors--to fair access to the EC and its member states. This requires a vigilant watch over current actions as well as proposed policies, whether at the level of the EC itself or by its member states. The economic and political importance of the EC to overall U.S. interests requires that the Department insure that U.S. commercial interests are pressed vigorously, yet with sensitivity to the longer run evolution of the EC.

Schedule

At the present time the U.S. is engaged in bilateral consultations with the EC over its implementation of the Florence Agreement and its rules of origin. We have engaged GATT Working Parties in consideration of member countries' schemes of export inflation insurance and Italy's prior deposit scheme for foreign exchange. The rules of origin issue is nettlesome and is expected to take considerable time--perhaps in the framework of the MTN--to resolve. We are hopeful that by mid-year 1977 real progress can be made on the Florence Agreement and export inflation issues, and that Italy will have found it unnecessary to maintain measures restricting its imports.

TRADE AND INVESTMENT PRACTICES OF CANADA

Background

The Canadian economy, which has been under wage and price controls for the past year, has been characterized by slow growth, inflationary pressures, and relatively high unemployment. Coupled with economic nationalism, these economic developments have invited governmental intervention in such areas as inward foreign direct investment, industry sectoral development, and regional economic development. The extent of our economic relationship with Canada means that its domestic policies often have direct and important implications for the U.S. (In 1975 U.S. two-way trade with Canada amounted to more than $44 billion. U.S. direct private investment in Canada was over $31 billion at the end of 1975, representing some 80 percent of total foreign direct investment in that country.)

Canadian governmental actions have included import restrictions in the textile sector, "offset" on major import transactions and threatened import protection for aircraft, and rejection of specific foreign investment proposals. Government involvement has also increased in the development and marketing of Canadian energy sources. That country's recent large deficits in automotive trade with the U.S. has brought pressure on the Canadian Government to seek changes in our 1965 bilateral free-trade agreement, which would require greater production of auto parts in Canada.

Issue

Formulate policies to safeguard access for U.S. trade and investment into Canada and to moderate Canadian pressures to revise the U.S.-Canada Automotive Agreement in a way which would adversely affect U.S. commercial interests.

Analysis of Issue

The size and complexity of our economic relationship with Canada dictates that the Department keep a careful surveillance over Canadian actions and respond quickly and appropriately to steps by the Canadian Government which adversely impact on our commercial interests. Insisting on our GATT rights and making known our official displeasure over specific actions in a timely fashion provide a useful approach to the problem. Exchange of visits by the Secretary and his counterpart in Canada provide another.

Schedule

Currently the U.S. is engaged in consultations with Canada under Article 19 of the GATT because of restrictive import measures Canada has taken which have affected U.S. textile trade. We are consulting with Canada under another GATT article to seek relief for U.S. liqueur exports coincidentally affected by Canadian restrictive action aimed at the EC. These consultations should be concluded by the spring of 1977. The Department expects to continue to press Canada bilaterally whenever its trade and industrial policies or screening of foreign investment appear unfair to U.S. economic interests.

JAPAN'S TRADE SURPLUS WITH THE U.S.

Background

Japan is the second largest trading partner (after Canada) of the United States, or third largest if the European Community is considered collectively. In 1975 it bought almost $10 billion of our goods and sold us over $11 billion of its merchandise. Since 1965 the United States has regularly posted deficits in its trade with Japan. For the past three years the deficits have been less than $2 billion. However, the situation has now changed significantly. Japan's trade surplus with the U.S. in 1976 is running at an annual rate of some $6 billion. On a global basis its surplus this year may be considerably higher.

A major share of Japan's imports is made up of industrial raw materials and agricultural and other commodities. Its exports are primarily manufactured goods. Such an imbalance has negative employment and income implications for Japan's trading partners, including the U.S. While an important reason for this development may be differences in the rate and timing of economic recovery in Japan and the rest of the world, questions still remain concerning Japan's relatively high import duties, its highly effective nontariff barriers (NTBs), and the Government's role in promoting Japanese exports. For example, Japan applies environmental and safety standards on automobile imports in a particularly onerous fashion. Further, Japanese Government procurement policy is very restrictive.

Issue

Formulate policies to deal with Japan's sizable trade surplus, including the possibility of obtaining improved market access in Japan.

Analysis of Issue

There is currently underway a study of the U.S.-Japan trade relationship by an interagency group chaired by the Office of the Special Representative for Trade Negotiations, in which Commerce has a lead role. Given the immediate concern over the size of Japan's trade surplus in 1976, there is a need to focus on possible actions by the U.S. Government to press Japan to improve access to its market. Improvements might take the form of specific steps to ease such NTBs as the administration of Japan's standards on automobile imports or, more broadly, to reduce duties on products of particular interest to the United States. In addition, and over the longer run, there is a need to develop a better understanding of how the Japanese Government influences private business decisions affecting imports and exports, as a basis for efforts to ensure fairness in that country's system of foreign trade.

Schedule

It is expected that the interagency study will be completed by the end of 1976. Over the next three months the analysis of options and a decision on possible actions should be made. Irrespective of the outcome of this interagency effort, the Department should continue its own analysis of Japan's trading system through 1977, pressing for change where circumstances indicate.

INTERNATIONAL TRADE AND INVESTMENT IN SERVICES

Background

The service industries (transportation, communications, advertising, auto leasing, data processing, hotels, banking, motion pictures, construction/engineering, etc.) have been providing the bulk of U.S. economic growth and now account for about 2/3 of U.S. GNP and employment. The United States is not alone in being a services-oriented economy; services account for about 50 percent of GNP in the other industrial nations.

Services are hard to define, measure, and analyze. Despite their predominant importance in the U.S. and other economies, little is actually known about the economic behavior of the service industries.

The factual background has been particularly lacking for international commerce in services, and services have generally been overlooked in policy formation and in previous trade negotiations. The Trade Act of 1974, however, included services for the first time within the President's trade negotiating authority. This inclusion was at the request of service industry representatives, who stated that their international problems had not been receiving adequate policy attention by the government.

Issue

How should policy attention to the international problems of the U.S. service industries be improved? The issue relates largely to changes that might be needed in policy forums and mechanisms. A particularly important aspect is deciding how much attention should be devoted to service industry trade problems in the Multilateral Trade Negotiations (MTN) and the means by which particular problems would be selected for negotiation.

Analysis of Issue

Commerce played the lead role in an interagency study on service industries' international commerce, an exhaustive study that was the first comprehensive examination of this issue. The study found that service industries' participation in world trade is actually quite small. U.S. service industries export only about $7 billion per year, compared with over $100 billion annual exports of U.S. merchandise. Most services by their nature cannot be exported; they must be produced when and where they are consumed.

The study found that the service industries' role in foreign investment was surprisingly large. Service industries account for almost 1/5 of total U.S. foreign affiliate sales (other than petroleum), and their sales are growing faster than those of U.S. goods-producing affiliates overseas. The international problems of the service industries were found to be overwhelmingly related to investment issues. Trade problems were in the minority and were found to be either unique to the particular service industry (such as maritime transportation) or to be remarkably similar to the trade problems of goods-producing industries. Government procurement and other non-tariff barriers typified the latter.

The study concluded that a highly-selective approach to service industry trade problems should be undertaken in the MTN, focusing on those trade barriers most related to the problems already under discussion in the MTN. The potential trade benefits from the MTN are overwhelmingly related to goods -- not services. The study also concluded that the investment problems of the service industries are not being adequately addressed. Their investment problems could mount in importance rapidly and are in need of significant policy-handling improvement. The problems of the insurance industry require particular attention.

Schedule

The study of service industry trade and investment has been completed, and all but one of its recommendations have been approved by the Economic Policy Board. The remaining recommendation (pertaining to a broad-ranging services trade and investment consultation committee) needs to be resolved. Subsequent to final approval of the recommendations, implementation awaits the formation of an inter-agency working group.

U.S. GENERALIZED SYSTEM OF PREFERENCES

Background

The U.S. Generalized System of Preferences (GSP), authorized by Title V of the Trade Act of 1974, was implemented January 1, 1976. The GSP fulfills a commitment made in the OECD and UNCTAD by the United States and seventeen other developed nations to extend general tariff preferences to developing countries to aid in their economic and industrial growth. The United States was the last of the developed countries to implement a scheme. Under the U.S. GSP, over 2,700 items from beneficiary developing countries enter the United States duty-free.

Issue

The interagency Trade Policy Staff Committee (TPSC), of which Commerce is a member, is responsible for the general management of the GSP, which includes the administration of public procedures whereby interested parties may request modification of the GSP product coverage. This latter task involves the review of requests received and the formulation of recommendations to the President for appropriate action on each request. The second semiannual review of such requests is currently underway. A general policy review of the operation and management of the GSP is planned for the spring.

Analysis of Issue

Regulations governing the administrative procedures for the modification of the GSP product coverage were published by the Office of the Special Representative for Trade Negotiations on December 31, 1975. Under the regulations, petitions requesting the addition of a product and those requesting a withdrawal must contain information relevent to the import-sensitivity of the product. Reviews are scheduled so that changes are made twice a year (on March 1 and September 1). Approximately thirty-five petitions have been accepted for the second review now in progress. In addition several other products in which beneficiary countries have a significant interest will be considered for possible designation as eligible products. The TPSC will hold public hearings on all of the products under review and then decide on the economic merit of each request.

The general policy review scheduled for the spring will address several issues which have become increasingly important during the first year of the GSP's operation, including (1) revision of the regulations governing the administrative procedures for product coverage modification; (2) clarification of the customs regulations regarding the rules of origin; (3) establishment of policy regarding the expansion of the product coverage, including the handling of diplomatic requests by beneficiary countries; (4) consideration of ways to improve the GSP which do not necessarily entail expanded product coverage; and (5) establishment of policy in regard to redesignation of countries which have been excluded by the competitive need limits.

Schedule

The TPSC will submit its recommendation regarding products being considered in the current review to the President in late January. Any resulting changes, along with adjustments required by other provisions of the Act (primarily the competitive need provisions), will become effective March 1, 1977. No definite dates have been set for the general policy review, but it is anticipated that it will be conducted during March and April, 1977.

RECEPTIVITY OF LDCS TO FOREIGN INVESTMENT

Background

In recent years many LDCs have come increasingly to view the history of trade and investment relations between the developing and industrialized world as having favored the developed nations and exploited the LDCs. They have been moved by the growing income gap between the rich and poor nations to adopt nationalistic economic policies which are hostile to the interests of the industrialized countries. These policies have been characterized by such actions as expropriations of foreign-owned assets, unilateral changes in investment contract terms, forced dilutions of foreign equity, and attempts to control or cartelize world supplies of key commodities.

The world faces a severe capital shortage in coming years, which obviously will have its harshest impact on the LDCs. In that international flows of private investment are an effective means to help meet the capital and technology requirements of these countries, it is vitally important that they establish and maintain an investment climate which attracts foreign-owned business enterprises. The strident language and harsh policies utilized by many LDCs against foreign investors have undermined their investment climate. In the long run, this has worsened their capital shortage problems and denied them badly-needed technology.

Some LDCs have sought to improve their terms of trade by attempting to raise the export prices of their key industrial commodities. Most attempts at forming cartels -- for example, in phosphates, bauxite, copper, iron ore, and tungsten -- have been largely unsuccessful. However, efforts to force up world prices and/or restrict supplies have caused deteriorating trade relationships and have rendered the processors of these materials less confident of their access to supplies. These efforts also have forced up the prices of manufactured goods, which further impacts on the LDCs.

Issue

The main issue is how to increase receptivity of LDCs to receipt of foreign investment as a principal means of fostering their development.

Analysis of Issue

The USG believes that a free and unimpeded international flow of trade and investment will result in the maximum benefit for the world as a whole. The United States attempts to reduce investment risk in the LDCs for U.S. investors through the Overseas Private Insurance Corporation (OPIC), which provides political risk insurance and guarantees.

The USG also participates in various attempts to devise investment codes to specify the conditions under which international investment should occur. One such code was formulated within the OECD as part of a broad declaration on international investment and multinational enterprises. Other efforts are continuing in various UN agencies and in the Conference on International Economic Cooperation (CIEC). The USG is of the opinion that such codes should be voluntary, and that they should specify certain responsibilities of host governments to foreign investors, as well as vice versa.

Such codes can prove useful in restoring world confidence in the value of international investment, and OPIC can eliminate some of the major impediments to U.S. investment in the LDCs. However, it is ultimately up to the LDCs themselves to pursue policies which attract investment from abroad and which promote freer trade.

Schedule

The OECD Guidelines for Multinational Enterprises were implemented in June 1976, as part of a broad policy statement on international investment. The USG is also working to ensure an environment more receptive to unimpeded international trade and investment in the various international agencies whose work is ongoing in this field -- ECOSOC, UNCTAD, the ILO, and the Commission on Transnational Corporations (UNCTNC) in the UN, and in CIEC and the Organization of American States (OAS). Both ECOSOC and the UNCTNC hope to have recommendations on drafts for codes ready for presentation to the next UN General Assembly session in the summer of 1977. This schedule is considered somewhat optimistic.

LDC FOREIGN INDEBTEDNESS

Background

Adverse economic developments during 1973 and 1974 have impaired the economic prospects for most of the non-oil exporting developing countries (LDC's). A sharp increase in oil prices, higher food and fertilizer prices in 1974, and sharp declines of other commodity prices, together with inflationary and recessionary tendencies in the developed countries, have placed serious burdens on the balance of payments of LDCs. Concomitantly, many of these countries have been unwilling or unable to cut back on their economic development programs. Despite drawdown of international financial reserves, disinvestment in stocks, and official support from many sides, including IMF as well as IBRD assistance, these LDCs have incurred large current account deficits (on the order of $27 billion in 1974 and $35 billion in 1975) and increased their external debt substantially to close the widening gap. This debt is estimated to total at least $151 billion.

Issue

The debt problems of the LDCs continue to be examined in several international fora, and LDC debt relief is now a principal issue in the North/South dialogue between developed and developing countries. The LDCs are pressing for not only generalized debt relief but also for a moratorium on repayments owed by the least developed countries. The creditor countries, including the United States, have resisted these demands, have focussed attention on the overall balance-of-payments situation of the non-oil LDCs and have looked for ways to improve the traditional case-by-case approach to the debt crisis situation.

Analysis of Issue

Commerce has taken an active policy interest in the debt problems of the LDCs. Improvement of the LDC debt servicing situation is necessary to avoid disruption in international trade and investment. Accordingly we have participated actively in discussions in the National Advisory Council on International Financial and Monetary Policies (NAC), preparations of U.S. positions for the Commission on International Economic Cooperation (CIEC), and inter-agency discussions preparatory to IBRD-sponsored individual country Consultative Groups. We have agreed with Department of

Treasury positions which emphasize that LDC balance-of-payments difficulties should be met by adopting domestic and external policies which avoid the need for debt relief. However, we have also, along with Treasury, been sympathetic to the need for individual debt relief where needed, and to the acceleration of the flow of resources to the developing countries, where justified. With regard to the poorest among them, we are also willing, with other agencies, to consider broad-gauge solutions involving official assistance, improved access to capital markets, direct investment flows, and specific financial programs under the guidance of the IMF and the World Bank.

Schedule

We do not anticipate that there is any possible early positive resolution of this issue.

TECHNOLOGY TRANSFER AND U.S. TRADE

Background

Technology is an important determinant of trade flows, as well as being instrumental in economic growth and productivity advances. A key foreign concern in the 1950's and early 1960's was the "technology gap" that existed as a result of the huge U.S. technological lead. Increased foreign research expenditures and the transfer of U.S. technology to other nations through U.S. multinationals, licensing, and other channels have acted to reduce this gap with other developed nations. The less-developed nations (LDCs), however, have not benefited as greatly from technology flows. The LDCs believe the effectiveness and rate of technology transfers to their economies must be increased if they are to attain a faster rate of economic development.

Issue

Accelerated technological growth in the developed nations, partially as a result of U.S. technology transfers to them, has caused concern regarding the future competiiveness of U.S. exports. Many observers believe that U.S. manufactured goods are not price-competitive in world markets, and that U.S. products are purchased abroad principally for their technological superiority. Transfers of U.S. technological "know-how" are believed by many to allow foreign nations to produce for themselves products they would otherwise have imported from the United States. This, it is feared, leads to reduced U.S. exports, higher U.S. imports, and the "export" of U.S. jobs. The large decline in the U.S. manufactured goods trade balance between 1964-72 is frequently cited as being the result of declining U.S. technological advantage.

Other observers believe that technology is but one of many factors influencing trade flows. They point to the overvalued dollar as the principal reason for declining U.S. trade balances through 1972, noting the huge surpluses in manufactured goods trade enjoyed by the United States since the 1973 devaluation.

Thus a variety of issues regarding government policy toward the restriction or promotion of U.S. technology transfers are of current concern. At the core of most of the issues is the question of whether such transfers are beneficial or harmful to U.S. trade and economic welfare. The argument has also extended to national security, when defined in the broadest sense of overall economic strength.

One of the most pressing aspects of the issue is the desire of the LDCs for more rapid inflows of technology. Key questions relate to the availability, utility, and price of such transfers, as well as to the consequent results on world trading patterns. Some observers claim that increased transfers of technology to the LDCs would enhance their economic growth and the size of their markets for U.S. goods. Others claim that the result of such transfers would be reduced LDC markets for U.S. goods and increased exports of LDC goods to the United States. Thus they fear jobs as well as technology would be transferred.

Analysis

A major problem is the lack of facts. Claims and assertions are in abundant supply, but few statistics and measurements exist. Most participants to the issue argue from the basis of individual "case studies". There is little agreement on how to define or measure technology flows or even on how to define a "technology-intensive" product. The assessment of costs and benefits is thus extremely difficult.

In addition, the relationship between technology and trade performance is still little more than theoretical. The degree to which U.S. trade performance requires a technological lead needs further analysis to relate trade and technology transfers to other economic forces such as exchange rates, labor costs, and factor productivity. Little is known about the longer-term economic welfare implications of comparable technological levels among developed nations. Policy actions could have far-reaching implications, and have to be based on the soundest possible factual basis.

Schedule

As a means of improving the factual base, BIEPR's Office of Economic Research is constructing a consistent means of identifying U.S. and foreign output having a high technology content. This measure, which should be of significant aid in assessing trade patterns and impacts, is scheduled for completion by mid-summer 1977. As a further step, a conference has been proposed to assess the economic implications of faster foreign technology growth. If approved, the conference would be scheduled for November 1977. The LDC aspect is being addressed by the Department through the Interagency Working Group on Technology. Immediate tasks include formulating plans for a National Conference in 1977 to involve the private sector in the transfer of industrial technology to the LDCs, and identifying the legislative and budgetary constraints of government agencies in helping the LDCs to develop an indigenous technological capability.

BRAZIL'S AVIATION FUEL TAX

Background

Commerce has been requested by the National Air Carrier Association, on behalf of Trans International Airlines, Inc. (TIA) and World Airways, Inc. (World), to make a finding that Brazil does not grant substantially reciprocal privileges (i.e., fuel tax exemptions) to U.S. carriers in connection with the purchase of aviation fuel in Brazil. Such authority derives from Sections 309 and 317 of the Tariff Act of 1930, as amended, and Section 4221 of the Internal Revenue Code of 1954, as amended, which provide for the exemption of foreign air carriers from the payment of U.S. cutoms duties, and internal revenue taxes (i.e., certain Federal excise taxes) on the purchase of supplies (including fuel) in the United States on a reciprocal basis.

The extension of these exemptions to the aircraft of a particular country requires a finding by the Secretary of Commerce that a country allows, or will allow, "substantially reciprocal privileges" to aircraft of United States registry. In 1953, the Department issued a finding that reciprocity exists in the case of Brazil. As a result Varig, the Brazilian flag carrier, enjoys full tax exemption on its purchases of fuel supplies in the United States whether for its scheduled or charter operations.

In Brazil, only Pan American and Braniff receive exemptions from the Brazilian federal aviation fuel tax (the so-called "sole" tax) which currently amounts to 34.9 cents per gallon. This exemption applies to both the scheduled and charter operations of these two U.S. airlines. However, TIA and World, the two U.S. non-scheduled carriers serving Brazil, are not accorded exemption from this tax.

Issue

Should Commerce rescind the 1953 finding of reciprocity with respect to the fuel tax, which would require Varig to pay a 1.5 cents per gallon tax and scheduled U.S. carriers could be made liable for a 34.9 cents per gallon tax in Brazil.

Analysis of Issue

In June, the Brazilians made an informal commitment to U.S. Ambassador Crimmins to extend the fuel tax exemption to U.S.

supplemental carriers. However, the Brazilians have been dragging their feet ever since, and it now seems doubtful that further progress can be expected. Because of the importance of this subject and its implications for U.S.-Brazil relations generally, we are recommending that the Economic Policy Board consider the matter and provide guidance.

Schedule

Commerce findings and recommendations will be ready for submission to the Economic Policy Board within 30 to 60 days.

ENERGY POLICY

There follow a series of 18 energy issue papers dealing with various aspects of energy policy. They involve energy pricing policy, conservation, Outer Continental Shelf development, impediments to coal development, synthetic fuel development, Alaskan energy, oil company divestiture, impact assistance, contingency planning, a variety of international questions, and the role of Commerce in the Energy Resources Council.

The Ford Administration's energy policy is set out in the Project Independence Report as updated in the President's February 1976 Energy Policy Statement and the 1976 National Energy Outlook. A Congressional scorecard of legislation enacted and not enacted is attached to this paper.

We are working with FEA on an Energy Policy White Paper which will provide a more comprehensive overview than the issue papers which follow. This paper will be prepared in time for testimony December 16 by Secretary Richardson, as Energy Resources Council Chairman, and FEA Administrator Zarb, before the House Interstate and Foreign Commerce Committee's Energy and Power Subcommittee. There are also certain classified papers which can be made available on certain of the international energy items.

The papers which follow deal with items which the Commerce Office of Policy has particularly followed. There is also attached to this paper tables prepared by FEA which show the anticipated impact of President Ford's program on 1985 import vulnerability.

CONGRESSIONAL SCORECARD

PRESIDENT'S BILLS PASSED & CONGRESSIONAL ADDITIONS

EPCA:
- STRATEGIC RESERVES
- STANDBY AUTHORITIES
- COAL CONVERSION
- APPLIANCE LABELING
- AUTO EFFICIENCY STANDARDS
- PRICE CONTROL PHASEOUT
- COAL LOAN GUARANTEES
- STATE CONSERVATION PROGRAMS

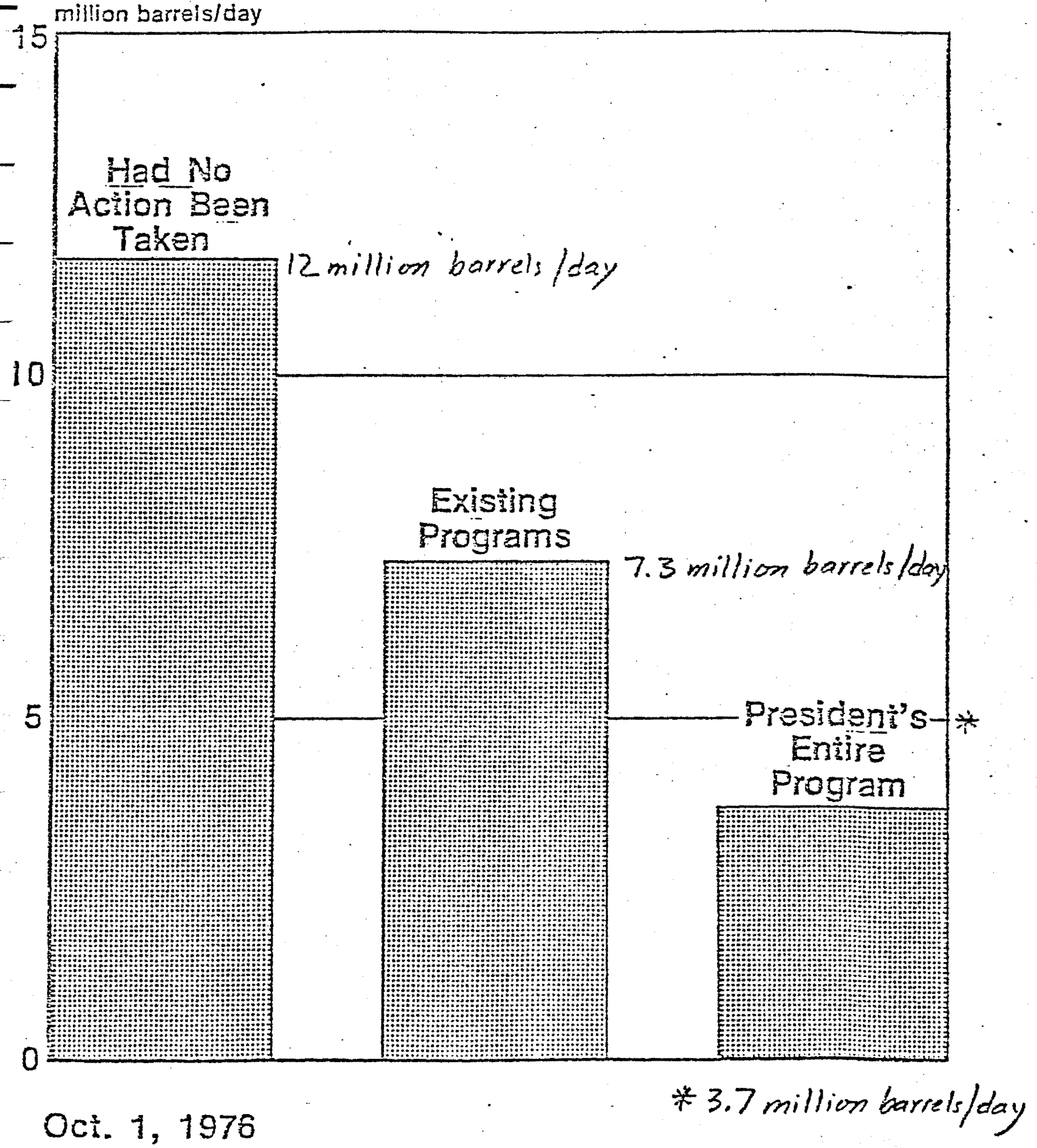
ECPA:
- BUILDING STANDARDS
- WEATHERIZATION
- CONSERVATION LOAN GUARANTEES
- UTILITY RATE STRUCTURE DEMO.
- INSULATION DEMO. PROGRAM

OTHER:
- NAVAL PETROLEUM RESERVES
- COASTAL IMPACT ASSISTANCE
- ERDA ORGANIZATION

BILLS REMAINING

- NATURAL GAS DEREGULATION
- NATURAL GAS EMERGENCY AUTHORITY
- SYNTHETIC FUELS COMMERCIALIZATION
- INSULATION TAX CREDIT
- ALASKAN GAS TRANSPORTATION
- NUCLEAR LICENSING
- NUCLEAR FUEL ASSURANCE
- CLEAN AIR ACT
- ENERGY INDEPENDENCE AUTHORITY
- ENERGY FACILITIES SITING
- UTILITY TAX INCENTIVES
- UTILITY REGULATORY REFORM
- OIL SPILL LIABILITY
- URANIUM ENRICHMENT
- IMPACT ASSISTANCE

New FEA Import Outlook: 1985



Oct. 1, 1976

Estimate of 1985 Imports if no Actions had Been Taken

Imports of reference case	5900
Deregulation of natural gas	2800
Decontrol of oil	1600
NPR production	200
Oil price effects	480
Synthetic fuels	350
Lower leasing schedule	400
	11730

The lower leasing schedule change is an estimate by I.C.F. Quantative numbers may be available by Friday.

Actions Already Taken

	Effect on Imports
Decontrol of oil (supply and demand)	2080
NPR Production	100
Utility Load Management	300
FEMP	260
Appliance Labeling	40
Weatherization and building standards	340
Industrial conservation program	140
Auto fuel efficiency	780
Conservation guarentees	75
State conservation plans	300
	4415

Actions to be Approved

Deregulation of natural gas	2800
Insulation tax credit	110
Accelerated OCS leasing	350
Synthetic fuels commercialization	350
	3610

IMPACT OF PRESIDENT'S PROGRAM BY 1985

	Import Vulnerability Reductions (000 B/D)	
Energy Supply		
- Deregulation of Natural Gas***	2800	
- Decontrol of Oil**	1600	
- NPR Production**	100	
- OCS Leasing	350	
- Synthetic Fuels Commercialization***	350	
		5200
Energy Conservation		
- Federal Energy Management Program**	260	
- Appliance Labeling/Efficiency Goals**	40	
- Insulation Tax Credit***	110	
- Weatherization and Building Standards**	340	
- Industrial Conservation Program**	140	
- Auto Fuel Efficiency**	780	
- State Conservation Plans**	300	
- Decontrol of Oil**	480	
- Utility Load Management**	300	
- Conservation Guarantees**	75	
		2825
Emergency Measures to Reduce Vulnerability		
- Standby Authorities**	1000	
- Strategic Storage System**	2700	
		3700
TOTAL VULNERABILITY REDUCTION		11,725 MB/d

** Enacted
*** Passed at least one House

NATURAL GAS PRICING

Background

The Federal Power Commission (FPC) regulates the prices of natural gas that is transported across State lines or international boundaries, including gas from the Outer Continental Shelf. Approximately 60% of the U.S. gas production is thus regulated (often referred to as "interstate gas"). The remaining 40% (referred to as "intrastate gas") is produced and consumed within the State of production subject to regulation only by state authorities. Most intrastate gas is located in Texas and Louisiana. The effect of price controls on interstate gas has been to keep prices substantially below the prices prevailing in the major producing States. Because of this price disparity, intrastate pipelines have generally been able to outbid the interstate pipelines for gas supply. The result is that Texas, for example, has in effect preferential access to gas produced within its own borders. Texas production declined last year about 5%, while her exports of gas declined about 15%. This price disparity has been a major cause of gas shortages in consuming States.

FPC regulatory policy is currently to vary the price of gas depending on when the drilling of the well commenced.

1975 or later	\$1.42/mcf (thousand cubic feet)
1973-74	\$ .93/mcf
Pre 1973	\$ .52/mcf or lower

Because of the large volume of natural gas sold under those older FPC contracts, the average price received by producers in April 1976 was only \$ .40/mcf, although gas sold in the interstate market from new wells obtains \$1.42/mcf and up to \$2/mcf or better when consumed within the producing State. The energy equivalent of imported fuel oil is approximately \$2.30/mcf in 1976.

In addition to making it difficult for consuming States to gain access to onshore gas, the low regulated prices have discouraged gas exploration and encouraged consumption, thus producing our current shortage of natural gas.

Finally, gas utilities have traditionally "rolled in" the prices of higher cost supplies, so that all customers pay a portion of the higher cost. Now that supplies of synthetic natural gas (SNG) and liquified natural gas (LNG) have the potential to become significant (with prices ranging as high as $5.00/mcf), the argument is made that incremental customers (either the newest user, or an industrial firm desiring more gas) should pay in full the incremental cost of the gas.

Issues

1. Should the Executive Branch continue to seek deregulation of new gas or place a tax on gas to bring gas prices up to market levels?

2. If the Executive Branch does seek high prices through some form of regulatory change, what solutions to particular sectoral burdens resulting from such higher prices should it seek?

Analysis

1. Higher Prices

It is clear that low prices for regulated interstate gas have contributed to the current shortage of natural gas by decreasing drilling, discouraging conservation, and giving first claim on onshore gas to producing States. These factors argue for decontrol. Opposition to decontrol is based on the fact that controls currently succeed in transferring large sums of money from producing interests to consuming interests.

The Ford Administration proposed decontrol of new gas while retaining controls on old gas. New gas was defined to include both gas from new wells and gas that had been sold within the producing State but was being shifted to the interstate market. By this method, it was expected that higher gas prices would gradually be phased in.

Even with decontrol of new gas, gas prices will remain for many years far below the price of competing fuels; this is due to the large volume of gas subject to long term contracts and regulation. Traditionally, utility commission regulation of prices to the final user is based on an average of the cost of all gas bought by the regulated utility. (This process is called "rolling in".) Thus, regardless of the price paid by pipelines for additional supplies of gas, the rolled-in price of gas will be low enough to assure that incremental supplies can be sold. In addition, the gas distribution industry has a major incentive to increase the size of its capital base which under State regulatory systems permits increased profits. Since increased capital bases depend on enlarged markets, gas utilities are inclined to market gas aggressively. Finally, gas utilities seek to avoid the political pressure which would result from customers going short of fuel.

These factors result in an industry willing to contract for high-priced gas from supplemental sources, including LNG imported from abroad, gas made from oil, and gas made from coal. Such gas is today priced well above the price of oil. Further, if the interstate market were not regulated, industry could be expected to offer high prices for new domestic gas in an effort to meet current market demand. Such high priced new gas, when averaged in with the price controlled gas, would still be competitive in the period after decontrol.

However, prices immediately after decontrol can be expected to tend to rise to levels that many would argue are excessive. Consumers within non-gas producing States will start to compete for gas which previosuly had remained in producing States, thus in the medium term increasing demand in relation to finite sources of supply. This will cause prices in gas producing States to increase. The problem may become especially acute in these States in that contracts are generally shorter. Since such prices would probably be above the price of oil, this could force massive conversions from gas to oil in the Gulf Coast region.

2. Solutions to Particular Problems

Possible solutions include (1) imposing a cap on new gas prices during a transitional period (this was incorporated in the original Nixon proposal in 1973); (2) imposing a heavy tax on either all natural gas use or on sales of regulated natural gas (see Tax Policy paper); and (3) using "incremental pricing".

The third possible solution would force new or expanding users to pay the price of the high-priced gas. One possibility is to apply such pricing only at the wholesale level, thus encouraging distributors and state regulatory commissions to support conservation measures, fuel switching and cessation of new deliveries. Incremental pricing could also be extended to sales to final customers. This version of incremental pricing, which has frequently been proposed, would have industrial customers pay for high priced gas, leaving the regulated, lower priced gas for the benefit of residental customers. The theoretical argument for having the industrial customers pay the price of the new gas is that, in the absence of this gas, there would be a shortage, which by standard curtailment practices would be borne by the industrial user. Thus, the new gas was really for his benefit and he should pay for it. It is also argued that there is greater latitude for industrial users to switch to coal or oil than there is for residential and small commercial users. Such a policy would discourage gas companies from contracting for high cost gas supplies because they would have only limited markets for it.

In Congress, incremental pricing in the form of "soak industry" has received support because it results in lower prices to politically more potent homeowners and commercial interests. In the simple form of guaranteeing cheap gas to homeowners, incremental pricing guarantees that gas will continue to undersell oil and electricity for new home use. The result of such a policy, if coupled with absolute priority in wholesale sales for gas allocated to homeowners and smaller commercial users, would be rapid growth in residential and commercial use. Nevertheless, current analysis suggests the total cost of supplying gas, including the cost of laying pipes in new suburbs, exceeds the cost of heating such new developments by oil.

Schedule

Legislation to deal with the pricing of natural gas is likely again to be introduced into Congress. And, incremental pricing issues will undoubtedly come up in conjunction with legislative proposals such as to import LNG, bring Alaskan gas to the "Lower 48", gasify coal, and allocate oil to plants making natural gas from oil.

DECONTROL OF PETROLEUM PRICES

Background

The Energy Policy and Conservation Act of 1975 (EPCA) authorizes petroleum and petroleum product price controls which expire in 1981. Forty months after passage, May 1979, the President may remove price controls from crude or products without approval of Congress. In the interim, the President may propose, subject to Congressional disapproval (one house veto), the removal of price controls from crude oil on a particular type of petroleum product.

With regard to petroleum products, middle distillates (home heating oil and diesel fuel), residual fuel oil, naptha jet fuel (military type jet fuel), and miscellaneous other products (lubricating oils, industrial solvents, petrochemical feed stocks, etc.) have all been decontrolled. A decontrol plan for gasoline has been prepared by FEA and recommended to President Ford for submission in 1977. If this plan is submitted and not disapproved by the Congress, kerosene jet fuel and propane gas would be the only remaining products under control. For those products decontrolled, prices have been decontrolled at the refinery, wholesale, and retail levels.

Crude oil prices, on the other hand, are still controlled, except for stripper oil (oil from wells producing less than ten barrels per day). EPCA sets an initial ceiling on the average composite wellhead price of all domestic oil of $7.66 per barrel. This composite price is designed to escalate over time and is now slightly less than $8.00 per barrel. The price control system provides for three tiers of controls: (1) with regard to old oil (oil from wells producing pre-May 1973) now an average of $5.15 per barrel; (2) with regard to new oil (oil from wells producing after that date) now an average price of $11.65 per barrel; and (3) with regard to stripper well oil which is now decontrolled.

Issues

1. Should the program of decontrol of product prices be continued to include gasoline? Options available to the Administration include:

a. Continue gasoline price controls;

b. Transmit to Congress full gasoline decontrol package(FEA is now holding public hearings);

c. Seek decontrol of retail and wholesale gasoline industry while retaining controls at the refinery level.

d. Seek to provide through entitlements on product imports sufficient foreign competition to keep gasoline prices from rising to the world level.

2. Should eventual decontrol of crude oil prices continue as a policy goal?

Analysis

1. Gasoline Decontrol

Gasoline accounts for about one-half of U.S. refinery output. Because of refinery, wholesaler and gas station competition, gasoline prices at all levels are now well below the legal ceilings; the existing controls thus have little practical effect at the moment. This situation is expected to continue into the indefinite future with regard to service station and jobber sales (wholesalers are referred to as jobbers in this industry).

Gasoline retailers and jobbers would generally like to be relieved of the burden of price and allocation controls. And, since competition is expected to keep prices well below legal ceilings, removal of controls at the retail and jobber level should have little, if any, effect on consumer prices.

Removal of controls at the refinery level poses more difficult questions. If the current surplus of domestic gasoline production capacity should disappear, prices could move up to the world level. Because American refineries can buy price controlled domestic crude oil, they have raw material costs substantially below the world level. Thus, if domestic gasoline prices are permitted to move towards world levels, much of the additional profits denied the major oil companies on crude oil could be recovered through refinery profits resulting from high gasoline prices. This could amount to $3.00 per barrel. We cannot predict accurately whether competition between domestic refiners will be adequate to hold refinery margins to a reasonable level if gasoline demand growth resumes.

An alternative to continued detailed regulation of refineries might be to use the entitlement program to encourage gasoline imports, thus permitting foreign refinery competition to restrain domestic prices. The entitlement program is primarily designed to provide entitlements to a share of old oil production to refineries which either have to import crude oil at international prices or use disproportionate amounts of high priced new oil. The program thus equalizes price differentials in different parts of the country resulting from access to U.S. domestic oil production. While the entitlements program is aimed primarily at crude oil, it has been expanded to include imports of residual oil in New England, thus reducing the high cost of "resid" to the New England area.

If entitlements are provided just with respect to crude oil, this provides an advantage to development of additional U.S. refining capacity in that U.S. refiners under the entitlement program can obtain access to U.S. domestic price controlled oil; and the difference between the U.S. average price and the price of imports permits the refinery, which has access to U.S. domestic crude, to undersell or make additional profits where there are no controls on the products produced. Entitlements for gasoline importers would tend to neutralize this advantage. Generally, providing entitlements to gasoline importers would give the same subsidy to gasoline importers as domestic producers of gasoline get.

2. Crude Oil Decontrol

The new Administration will have to decide whether to keep crude oil price decontrol as a long-term goal. The gradual crude price increases provided for in EPCA (approximately 10% per year) appear unlikely to bring domestic prices to the world level by May 1979 (at which time the President can remove price controls without veto from Congress). Thus, the new President will be faced with a decision on whether to permit crude prices to rise to the world level by decontrol. Such decontrol would transfer a substantial sum of money from consumers to producers. It would also encourage production, and some conservation, by providing for higher prices.

Schedule

1. Gasoline decontrol will have to be dealt with early, since the Ford Administration may have already submitted its plan to Congress. If it has not, it will be on the shelf ready to go. (FEA is now holding public hearings in preparation for possible transmittal to the Congress).

2. Although the industry will undoubtedly ask for an indication of the Administration's policy regarding crude prices early in the Administration, the first major action forcing event occurs in 1979 when Congress's veto power over Executive Branch authority to remove controls expires.

ENERGY TAX POLICY

Background

Prices for both oil and gas are controlled. As a result, these fuels are priced substantially below the cost of the imported oil. Any reduction in oil imports arising from greater conservation of oil and gas will save foreign exchange costs of $13.37/barrel. In contrast, the average crude price for domestic refineries is $10.38/barrel. The energy content of imported oil is worth about $2.30 per 1,000 cubic feet (mcf.) of gas. In contrast, domestically produced gas averages about $.41/mcf. when sold to major inter-state pipelines. These pipelines in turn sell to distributors (such as Washington Gas Light) at $1.00/mcf. and to industrial users at an average of $.89/mcf. The average retail price of natural gas sold to residential customers is only $1.80/mcf.

The result of this underpricing of oil and gas is inadequate incentive for conservation in that conservation opportunities would cost more than the fuel saved even though the saving on imports might justify the conservation measures as a matter of national interest.

One way to resolve this problem would involve some type of tax on oil and gas. Possibilities include separate taxes on oil and gas at different rates; taxes on regulated sales of these fuels to bring them up to market levels; or taxes on particular uses of certain fuels, such as industrial uses of oil and gas, or retail sales of gasoline.

Issue

What, if any, such taxes should be proposed?

Analysis

The theoretical argument for taxes to bring final prices of oil and gas up to the price of imported oil is set out above. Further, some conservation proponents contend that the conservation argument for such taxes is even stronger than the argument based on current underpricing. In addition, proponents of a gasoline tax argue that automobile use creates traffic congestion and air pollution in urban areas which could be reduced by a gasoline tax to control automobile use.

Opposition to such taxes has been strongest from those who feel that they put an excessive burden on low and medium income groups. But, income distribution objectives can be achieved through accompanying energy taxes with tax reduction for preferred classes. The one practical problem is that the very lowest income groups have been largely exempted from income taxes; hence any offsets in this case would have to be made by direct payments.

Tax proposals have met with considerable opposition in the Congress. The same forces that oppose deregulation oppose taxes. On the other hand, energy taxes could provide earmarked revenues for Government subsidies to energy development or conservation. Unlike deregulation, however, energy taxes shift resources to the public sector from the private sector, although deregulation accompanied by windfall profits taxes would have this same effect.

Some doubt the amount of conservation which would be achieved by high prices, arguing that industries and consumers do not pay that much attention to energy prices (in most cases it is a small proportion of operating expenses), and look only at first prices when purchasing equipment, automobiles, and appliances. However, if the tax is high, there is definitely potential for conservation, much of it being of a type that people will not be induced to undertake as long as energy is cheap.

Because oil and gas consumption varies with the region of the country, tax proposals may impose inequitable burdens on some areas. Oil use is concentrated on the East Coast while gas use is especially heavy in the Southwest and central regions (for home heating). Taxes on gasoline to reduce automobile use encounter opposition because the heaviest use is by residents outside of large cities while the benefits of reducing automobile use accrue disproportionately to residents of large metropolitan areas subject to pollution and traffic congestion.

Schedule

No immediate decision forcing event other than pressure to induce additional conservation.

ENERGY CONSERVATION POLICY AND IMPLEMENTATION OF CURRENT PROGRAMS

Background

The Ford Administration's energy conservation policy involves a series of energy pricing and conservation program actions. In the short term (i.e., the next 1-2 years), energy pricing, particularly increased prices of oil and natural gas resulting from deregulation, was expected to achieve the bulk of conservation. By 1985, however, the Ford Administration expected to achieve conservation through a variety of program and regulatory actions.

Thus, in addition to deregulation of oil and gas, the Ford Administration proposed seven energy conservation initiatives involving: (1) Federal Government energy management, (2) conservation in buildings, (3) conservation in industry, (4) conservation in automobiles, (5) airplane fuel conservation, (6) conservation R&D, and (7) state energy conservation programs.

By 1985, the following reductions in import vulnerability are expected from the following measures:

	Thousands of Barrels of Oil Equivalent Daily
- Decontrol of Oil**	480
- Deregulation of Natural Gas***	500
- Federal Energy Management Program**	260
- Appliance Labeling/Efficiency Goals**	40
- Insulation Tax Credit***	110
- Weatherization and Building Standards**	340
- Industrial Conservation Program**	140
- Auto Fuel Efficiency**	780
- State Conservation Plans**	300
- Utility Load Management	300
- Conservation Guarantees	75
	3,325

** Enacted
*** Passed at least one House

As can be seen, 9 of the 12 actions have either been enacted by legislation or implemented administratively. Of the roughly 3.3 million b/d expected to be saved in 1985, the measures currently being implemented are expected to achieve savings of 2.8 million b/d. However, nearly 500,000 b/d in savings are attributable to decontrol of oil, and actual decontrol is until 1979 subject to Congressional veto. Nevertheless, we believe the necessary authorities for approximately 85% of President Ford's energy conservation program are in place.

Energy conservation, which is very much a "White Hat" issue, is continually mentioned as the best means for reducing in the short term U.S. energy vulnerability. Certainly, energy conservation is conceptually an appealing way to reduce our energy problem; conservation also has environmental benefits. The problem is: neither the Executive Branch nor the Congress has so far found ways in which the contribution of energy conservation can be significantly increased over and above existing legislation without affecting economic growth or life styles to a politically unacceptable degree. Some would argue that the EPCA 27.5 mpg fleet average for automobiles requirement by 1985 is already too high a target in this respect.

There is also a coordination problem. Existing legislation, in particular the Energy Policy and Conservation Act of 1975 (EPCA) and the Energy Conservation and Production Act of 1976 (ECPA), authorized many major programs to achieve a greater degree of energy conservation. These programs involve 15 major agencies. In many cases, several agencies are involved in one aspect of the program. In all cases, there is a question of how to link energy conservation R&D to the national conservation programs. While coordination is taking place at the agency level, no overall guidance is at present being provided to assure harmonization of programs in meeting national goals.

Immediate action is required to effect better coordination of Federal efforts in the area of energy conservation standards in buildings. This need devolves in part from the need of state and local governments with statutes already on the books to meet schedules mandated by law. Efforts involve specifically HUD, FEA, ERDA and the National Bureau of Standards. Essential research tasks in NBS and ERDA are being delayed because of the absence of coordinated leadership.

Section 162 of ECPA requires the ERC to prepare a "report on national energy conservation activities which shall be submitted to the President and the Congress annually beginning July 1, 1977." The report is to include (1) a review of all Federal energy conservation activities in relation to national conservation targets and plans, (2) an analysis of sectoral conservation targets and progress towards their achievement, (3) a review of progress under State energy conservation plans, (4) a review of private sector conservation efforts, and (5) an assessment of whether existing conservation targets are adequate and whether additional incentives, programs or mandatory measures are necessary. The report is to be coordinated by the Chairman of the ERC.

Energy conservation encompasses many different concepts, all of which are important; among them are:

- Manufacturing process efficiency
- Service industry process efficiency
- Product efficiency which involves product equipment and materials substitution
- Fuel efficiency by which the right fuel is selected for the right task
- Operational efficiency which begins with a conservative attitude not yet acceptable to all energy users, but relates to use of all building vehicles, appliances and other energy consumptive items within design parameters for optimal energy efficiency

The ERC report should advise on each aspect of energy conservation and the type and level of incentives and disincentives appropriate.

Issues

As a matter of national policy, we should try to solve as much of our energy vulnerability problem as possible through energy conservation consonant with economic growth objectives. The issues are:

(1) To what extent does energy pricing result in greater efficiency and/or lower consumption?

(2) To what extent should our conservation efforts be based on conversion from scarce to abundant fuels?

(3) What existing programs are not cost effective?

(4) What additional incentives or programs might be desirable?

(5) To what extent, and in what areas, should mandatory measures be used?

(6) What additional coordination of implementation of existing programs is needed?

Analysis of Issues

While various analyses have been made of the effectiveness of different kinds of conservation measures in achieving our energy goals--by the Executive Branch, the Congress, and others--and while a number of conservation programs are already in place, we have yet to undertake an across-the-board assessment of experience with current authorities which have been in place long enough to permit their evaluation, make projections of the likely energy impacts of current authorities with which we have not yet had experience, and assess what is most likely to be needed in the future. The first ERC report, due in July 1977, could provide a vehicle for such an analysis. It would also allow us to separate out energy conservation as a priority part of the solution to the energy problem. Since traditionally energy consumption has been closely linked to economic growth, it is of the highest importance that we carefully balance measures to achieve reduced energy consumption goals with our economic goals. Any across-the-board analysis should deal with this issue.

Based on current analysis, it is clear that a mix of energy conservation measures is most likely to achieve cost effective savings. Energy pricing is only a part of the answer. At the same time energy conservation cannot in all cases be willed from Washington. Mandatory energy consumption standards in many cases may be difficult or impossible to implement and may do more damage than provide benefits. In industry, which consumes 43% of energy, it is most doubtful that energy consumption standards would provide benefits in excess of costs and would be virtually impossible to administer in an equitable manner. Processes are different from, say, one cement plant to another; and energy consumption depends on capacity utilization, feed stocks and availability of energy supply. With regard to consumer products, it is possible to regulate energy consumption by such products (e.g., automobiles, appliances); but arbitrary standards may not optimize costs and benefits. Information to consumers, through product labelling, on the other hand, could bring about the same result on a market basis. Nevertheless, where a product consumes a significant proportion of a scarce fuel, such as gasoline by autos, legislation has been enacted to require certain energy efficiency standards. However, insufficient analysis has been given to the precise level of these standards.

Schedule

We have proposed establishment of an ERC Committee on Energy Conservation to coordinate existing Federal programs and prepare by July 1, 1977, the first report to the President and Congress on this subject.

IMPACT OF CLEAN AIR ACT
ON COAL USE AND DEVELOPMENT

Background

The principal limitation on consumption of coal in the United States is not the ability to produce coal or transport it, but the size of the markets in which it can be legally burned in accordance with provisions of the Clean Air Act.

Public Law 91-604, the Clean Air Act Amendments of 1970, provided for the establishment of National Ambient Air Quality Standards (NAAQS) for several air pollutants. Primary NAAQS, which provide for protection of public health with an adequate margin of safety, were to be achieved by July 1, 1975. "Secondary" standards, set to protect public welfare, are to be achieved as soon as practical. Enforcement of these standards at the State level is provided for by the Act. States are required to develop EPA-approved State Implementation Plans (SIPs) incorporating NAAQS or more stringent state standards.

New Source Performance Standards (NSPS), mandated by the Clean Air Act, establish nationwide limits for emissions of pollutants from all new stationary sources. The law requires that NSPS reflect the degree of emission limitation achievable through the application of the best system of emission reduction, taking into account the cost of achieving such reduction. The Administrator of EPA has determined that the NSPS for SO_2 can be met by stationary source utilization of scrubbers (devices for removing SO_2 after burning) or low sulfur fossil fuels. In the case of coal, this requires use of coal with not more than .7% sulfur content.

The United States District Court for the District of Columbia, in a decision upheld by the United States Supreme Court, held that the Clean Air Act also requires that SIPs must provide for the prevention of significant deterioration of air quality in those areas where ambient air quality is better than that required by secondary NAAQS.

The Supreme Court held that the reference in the Preamble of the Clean Air Act to avoiding deterioration of air quality requires emission regulations in areas which are now clean in order to protect current levels of air quality. Depending on the exact nature of the emission regulations adopted for such now clean areas, the effect is likely to be either imposition of costs in excess of benefits (there is no provision for comparison of benefits versus costs in either the law, federal regulations, or applicable court cases) or possibly prevention of large scale development in certain rural areas. New power plants and coal mining or gasification facilities in rural areas are likely to be impacted by these provisions.

In accordance with applicable Court decisions, EPA has promulgated regulations to enforce the significant deterioration ruling. These provide for dividing the currently clean areas into three categories in each of which different standards would be applied. The highest standards would be applied to national parks and monuments or to regions adjacent to them (Class I areas). The lowest standards would be applied to areas intended for development (Class III). The States would have considerable discretion as to which areas would be classified into which category. In virtually all cases, the level of emission control would exceed that which could be justified on the basis of identifiable economic benefits or protection of public health. Justification of the "significant deterioration" provisions thus rests on aesthetic considerations such as preventing reduction in visibility, as for example in certain Western areas.

In implementing the Clean Air Act, State regulation exceeds in many cases the levels needed to achieve the minimum standard of air quality required by Federal law. This was frequently because regulations, which were designed to deal with pollution problems in the most polluted urban areas of the State, were made applicable to an entire State or a large area of a State. The result was regulation far in excess of what was required under national standards for rural areas. It soon became clear that meeting these standards in the eastern United States would require either more low sulfur coal than was physically available or more installation of scrubbers than would be possible in the short run. This situation was dealt with by delaying enforcement of regulations beyond the mid-1975 deadline, and by efforts to relax regulations in rural areas.

Further, regulations under the Clean Air Act have been written to require emission control such that air quality was maintained even under the most adverse meteorological conditions. This meant that the regulations adopted were far more stringent than required to protect public health and welfare under normal meteorological conditions.

An alternative strategy, referred to an intermittent controls or fuel switching, is technically feasible. This involves burning low sulfur fuels (oil, gas, low sulfur coals) during periods of adverse meteorological conditions, and burning high sulfur fuels (typical eastern coals) at other times.

Issues

1. Should amendments to the Clean Air Act be sought to permit development of large new coal using facilities in rural areas?

2. To what extent should the Federal Government encourage pollution regulations that vary within the regions of a State?

3. To what extent should the Federal Government encourage emission regulations that vary with the meteorological conditions?

4. Should amendments to the Clean Air Act be sought to permit standards to take into account whether benefits exceed the costs?

Analysis

1. Amend Clean Air Act

Various proposals have been made to modify the Clean Air Act to permit additional industrial development in the now clean areas. These have ranged from removal of the language of the Preamble of the Act that originally created the problem to various proposals to set up new regulatory systems for the clean areas. The parts of the country most seriously affected are the western areas where large new coal using facilities including power plants and gasification facilities may be constructed (Wyoming, New Mexico, Montana); various areas now relying on natural gas which will be forced to convert to oil or coal in the future; and rural areas in other parts of the country.

A policy of no increase in pollution in unpolluted areas, combined with the current policy of no new major pollution sources in major urban areas which exceed ambient air quality standards, places significant constraints on siting of new coal using facilities. At worst, major new pollution sources may be permitted only in the moderate pollution areas where reduction in emissions from existing sources permits the start-up of new sources without either increasing the total level of emissions or exceeding the legal standards. Another possible outcome involves very heavy expenditures for the "best available" emissions technology (scrubbers on every plant) but does permit development to proceed.

2. Variable Standards

A policy of lower pollution standards in rural areas appears capable of both reducing public health hazards and encouraging the use of coal. The improvement in public health results from the probability that major pollution sources would relocate to rural areas if given the financial incentive of low pollution costs. Given the lower population densities in rural areas, the total intake of pollutants into human lungs is likely to be reduced by a policy of relocation more than a policy of maximum controls everywhere. Current scrubber technology would provide for removal of about 90% of emissions. A plant relocation from an area of 10,000 people per square mile to an area of 100 people per square mile would reduce the amounts of pollutants breathed by 99% at low cost.

3. Intermittent Controls

A strategy of fuel switching during periods of adverse meteorological conditions has considerable potential for both achieving air quality and permitting the burning of coal.

4. Cost-Benefit Analysis

The current law, in effect, treats clean air as something which is always worth purchasing regardless of what the costs are, or whether they exceed the benefits. An approach which would to a greater extent relate costs and benefits has obvious attractions.

Schedule

Action on significant deterioration will probably be forced by introduction of numerous amendments to the Clean Air Act in the early days of the next Congress. Modifications to State regulations for regional variations in emission standards and fuel switching strategies will from time to time require EPA approval or disapproval.

SYNTHETIC FUEL FINANCING

Background

Immediately after the petroleum price increase of late 1973 and early 1974, it was widely believed that synthetic fuel (synfuel) development would prove economical. For example, oil companies bid $400 million for oil shale leases and expressed an intention to go into full scale oil shale production. Belief in synfuel economic viability underlies the million barrel per day goal expressed in the 1975 State of the Union message.

It soon became clear, however, that shale oil and synthetic fuel from coal development was, in general, not economical, even at current high oil prices. Thus, the Administration pushed for a program to demonstrate commercial synfuel plants. A start could be achieved by using existing ERDA demonstration plant authority. In addition, the Ford Administration supported authority to encourage synthetic fuel development through grants, price supports and loan guarantees. By making loan guarantees non-recourse, the government would repay the loans if the project failed. Such legislation was narrowly defeated in the 94th Congress.

Synthetic fuel commercialization is different from research and development. Most of the expense associated with a commercial scale plant involves known technology--mining, materials handling, oxygen production, steam generation and petroleum refining. A commercial scale oil shale plant or coal gasification plant involves a system composed of a series of identical production units. Thus, oil shale and coal process technology can be tested by building only one full scale unit. In the case of coal high BTU (pipeline quality) gasification, the only process that is available for immediate commercialization is the Lurgi process. This was developed in Germany before World War II and has been used in numerous foreign countries. Production of Low BTU, non-pipeline quality gas for on-site power generation and industrial use has also been tested from a technological point of view in many different parts of the world.

Thus, justification of a synfuel commercialization program does not rely on technical research considerations per se. Rather, it is argued that the environmental and economic impacts of full scale commercial operation can only be understood by actually building and operating several full scale plants. It is further thought by some that a demonstration of U.S. alternatives to OPEC oil might be useful in keeping prices down. Others argue that such a program would confirm the fact that the cost of most synfuels is far above current oil price levels and thus support the OPEC argument that oil at current OPEC prices is still a bargain.

The quantities of fuel that will be produced from synfuel commercialization will be quite small (250,000 barrels of oil equivalent/day) and are thus unlikely to make a substantial contribution to self-sufficiency. Two hundred fifty thousand barrels of oil a day would be only 1.4% of current U.S. consumption. However, in the case of natural gas, the quantities of gas that could be produced might be significant if directed towards California markets.

In the last several months, a number of new developments have occurred with regard to development of shale oil. Most of the shale oil experimentation has involved above ground shale retorting (heating of the shale rock so that the oil is forced out); this technique, however, has a number of environmental problems, in particular disposal of spent shale and air pollution. On the other hand, Occidental Petroleum has developed a process which would do the retorting in the ground (modified in situ process). This process reduces considerably both the spent shale and air pollution problems. It also involves a much lower capital cost, approximately one third of the equivalent surface shale retorting.

Occidental is currently considering joint development with Ashland of one of the Colorado Federal oil shale leases, and a modified development plan is expected to be submitted to the Interior Oil Shale Supervisor in the next several weeks. Occidental believes that its process is economic at current oil prices, and states that it does not need Federal Government financial assistance to move forward.

One further special problem involves the fact that ERDA is using its research authority to construct a full scale gasification plant using eastern coal in Illinois. A very high proportion of the cost of synthetic gas involves the cost of coal. By far the lowest costs are achieved by using cheap Western coal strip mined from thick deposits. Western coals also have certain technical advantages relating to their agglomeration properties at high temperatures. The Texas gas that would have gone to California can be replaced with Western gas from coal. The excess capacity in existing pipes can then be used to deliver the natural gas that would have gone to California to the East. The result is very low cost transportation. There appears virtually no chance that high BTU synthetic gas developed from Eastern high sulfur coals will be cheaper in any part of the country than gas from Western coals delivered by the above described exchange process.

Issue

Should the new Administration propose a program of assistance to industry to commercialize synfuels?

Analysis

With regard to liquid fuels from coal, the costs appear to be above current oil costs by a large margin. There is not yet an economical coal liquifaction process ready for commercialization. Although several processes are in the pilot plant stage and appear technically feasible, the most immediate commercialization issues are unlikely to involve liquifying coal.

Three full scale plants have been proposed by natural gas companies (two in New Mexico for the California market, and one in North Dakota for the Midwest) to produce pipeline quality gas from coal. All would use well developed German technology and appear technically feasible. Nevertheless, the cost of the gas from these projects would be above the cost of oil refined and delivered to industrial users who would be interested in such synthetic natural gas to replace current natural gas supplies subject to cut off.

There is a nationwide gas shortage. While the shortage is not yet serious for the areas in Michigan and Wisconsin that could be served by the North Dakota plant, the Michigan-Wisconsin Pipeline situation will gradually grow worse. The shortage in California is more serious and is expected to grow gradually worse with the depletion of supplies in West Texas.

To actually finance the proposed synthetic gas plants, investors must be assured of recovering their investment plus a normal return. Such assurances can be provided either by the gas customers through what is called an "all events tariff" coupled with rolling in the price of the synthetic gas with the price of controlled domestic gas, or by direct Government guarantees or some other form of subsidy.

Under an all events tariff, the gas distributors would in effect commit to pay the cost of the synthetic gas plant regardless of what these costs were. Naturally, consumers and utility regulatory commissions (e.g., the California Public Utility Commission) are reluctant to commit the gas consumer to such large and unknown expenses.

With regard to shale, the situation is less clear. Above ground oil shale development is probably uneconomic at current prices of oil with which oil from shale directly competes. Further, environmental opposition to above ground oil shale development remains strong. On the other hand, if Occidental, or some other company, proceeds with in situ retorting and Occidental's assertion is correct that their process is economical at current prices, oil shale may well proceed, at least to the stage of demonstrating commercial production at a level of approximately 50,000 b/d. The modified development plan which Occidental is currently working on with Ashland should give us some indication. Finally, since Occidental claims they do not need Federal financial assistance, it would seem that we should defer considering major Federal financial assistance pending review of the development plan. This view is shared by the Department of Interior; but not ERDA which is considering additional funding for demonstration of above ground retorting.

Finally, the basic question of whether the new Administration should propose a synfuel financial assistance program involves an assessment of whether the real impediment to commercial development in fact involves scale-up uncertainties and the possibility of reduced oil prices which would undercut synfuel economics.

If synfuels are clearly uneconomic, we probably should not subsidize their development. If, on the other hand, they are likely to become economic in the medium term (i.e., before 1990), then an argument can be made that the Federal Government should provide necessary incentives to get the industry started. The question is: are incentives really necessary? They may not be for shale. An "all events tariff" might be a more effective way to get synthetic natural gas started and would place the choice and risk on those utility commissions and consumers directly affected. Coal liquifaction is probably uneconomic given the present state of the art.

The above analysis, of course, does not preclude Federal R&D assistance to assist in developing new technologies which have potential for producing synfuels at economic prices. This is the primary role of ERDA.

Schedule

1. Shale oil decisions will be forced by the expiration of the one-year suspension of lease payments on the existing shale oil leases in late 1977.

2. Pressure from gas users and project proponents for Federal support for coal gasification plants can be expected early in the Administration.

OUTER CONTINENTAL SHELF LEASING LEGISLATION

Background

Major amendments to the Outer Continental Shelf Lands Act to change the OCS leasing process were debated in the 94th Congress, passed both Houses, and actually resulted in a Conference Report. However, due to industry and Interior opposition and the rush of other legislation in the waning days of that Congress, legislation was in fact not passed.

The legislation would have encouraged leasing methods other than cash bonus bidding, including bidding on the basis of the percentage of the value of production given to the Government (royalty bidding) or on the basis of a percentage of the profits going to the Government. Other provisions would have encouraged oil company exploration before leasing, provided for an Offshore Oil Spill Pollution Fund, and distinguished between development and exploration. The legislation also provided for a greater role for State and local governments and contained various provisions of a procedural nature which Interior felt would greatly delay OCS development.

There is continued dispute between those concerned with environmental protection and those concerned with energy development regarding development of the so-called OCS "frontier" areas in the Atlantic, Pacific, and off Alaska. Most of the good acreage in the Gulf of Mexico has been leased, and any large increases in offshore production will have to come from these other areas.

A surplus of relatively high sulfur oil is currently expected on the West Coast, and any additional OCS leasing in the Pacific and off Alaska would add to the surplus and hence the amount of West Coast oil that must be transported to the eastern part of the country or sold abroad. Assuming that offshore oil also has relatively high sulfur content, questions are raised whether additional leasing in these areas would add to any surplus.

Issues

1. What, if any, amendments to the Outer Continental Shelf Lands Act should be sought in the new Congress?

2. What areas should be offered for leasing?

Analysis

1. Amendments to Outer Continental Shelf Lands Act

The Department of the Interior, which administers Outer Continental Shelf energy exploration and development, had major objections to the proposed amendments as they passed the House and Senate. Oil companies also objected to these amendments as being disruptive to orderly and balanced development of offshore oil and gas resources.

On the other hand, while Commerce agreed with Interior that additional OCS legislation was probably not necessary, we were not as convinced that the OCS Amendments, as they emerged from Conference, would be totally disruptive of OCS development. We were in the process of preparing an analysis for Secretary Richardson in this respect when the Congress decided not to pass the bill this session.

We can expect new OCS legislation to be introduced in the 95th Congress. Given NOAA's expertise in the area and based on environmental baseline studies which it does for Interior, we should take an active role in working within the Executive Branch, and as appropriate, with Congress in assuring that the new Administration's position and any legislation which emerges from the Congress is balanced between developmental and environmental concerns.

2. OCS Leasing Schedule

This item is currently the subject of ERC discussion. Interior is proposing a stretch out of the schedule with the following characteristics:

-- It extends the schedule into 1980 and provides for consideration of six sales a year.

-- It provides for sales on approximately a yearly basis (8 to 14 mos.) in the Gulf of Mexico in order to minimize drainage of common resource pools on adjacent lease sites, and to provide for leasing of deep water acreage and acreage contiguous to new discoveries.

-- It provides for second sales in frontier areas in the event that commercial discoveries are made.

-- It defers the decision on whether to consider leasing off Oregon, Washington and Northern California until the results of the call for nominations and request for comments are fully analyzed.

-- It defers the decision on when to consider leasing in the Outer Bristol Basin off Alaska until additional environmental studies are completed.

-- It limits the leasing area of consideration for the Beaufort Sea and Bering/Norton off Alaska to that which is shoreward of the 60 foot isobath or the shear zone (between sea ice and shorefast ice).

Commerce believes that lease schedules should be based on information to be derived from the Bureau of Land Management (BLM)/NOAA OCS Environmental Assessment Program. Waters adjacent to Alaska are extremely rich in fisheries resources. Effort should be made to minimize the impact of offshore development on these resources.

It is also important that coastal zone management programs be operational in at least those coastal areas directly impacted by lease sales, prior to approval of field development plans. Alaska should be given adequate time to meet this goal.

For these reasons, NOAA had proposed lease schedule changes off Alaska. These changes were generally taken into account in the new Interior proposed schedule.

Schedule

1. OCS legislation will probably be reintroduced in the Congress and will move rapidly since much of the work has already been done.

2. Several of the decisions to lease will prove controversial. This will be true of leasing off New England in the vicinity of George's Bank (scheduled

for June 1977), the South Atlantic (scheduled for September 1977), and for leasing in the vicinity of Kodiak Island off the South Coast of Alaska (scheduled for November 1977).

3. The Department should early take an active role in this area in the new Administration.

ALASKAN OIL TRANSPORTATION

Background

There will initially be substantially more oil available to the West Coast of the United States after start-up of the Alaskan oil pipeline than there will be refinery capacity or markets to absorb it there. The surplus in 1978 is expected to be on the order of magnitude of 500,000 barrels per day (b/d). At the time of passage in 1973 of legislation providing for construction of the Trans Alaska Pipeline, it was generally believed that all of the North Slope oil would be consumed on the West Coast. This assumption no longer appears valid due to a combination of events which have occurred since 1973. The economic slow down, the Arab oil embargo, subsequent higher oil prices and conservation, as well as the opening to production of the Elk Hills National Petroleum Reserve, have all contributed to changing the West Coasts' demand/supply situation.

The Alaskan oil is also of relatively high sulfur content and produces a high yield of residual fuel oil making it unsuitable for many of the existing West Coast refineries. The refineries in the State of Washington (except for the Atlantic Richfield refinery) were built to use low sulfur Canadian crude and cannot process Alaskan crude without substantial modification. The California refineries can physically process the oil, but to a large extent lack the desulfurization facilities to produce the low sulfur products required to meet California air pollution regulations. Thus, Alaskan oil cannot displace current imports of low sulfur Indonesian oil.

While refinery modifications to use Alaskan oil are possible, current price controls do not provide for recovery of the cost of such modifications. Such modifications are not expected in the near future.

Current law forbids export of oil transported through the Alaskan pipeline except for exchange with an adjacent country (Canada) to facilitate transportation; or if the President finds that "such exports will not diminish the total quantity or quality of petroleum available to the United States, and are in the national interest". If the President decides to recommend such exports, Congress has veto power by concurrent resolution. Since this alternative involves administration of export controls, Commerce will have an important role to play in any such possibility.

If the oil is shipped to Japan or other Far Eastern countries, it would presumably take the form of an exchange. This is a technique commonly used in the petroleum industry by which oil in one location is exchanged for oil in another location more convenient to the user. In this case, we would exchange Alaskan oil for Middle Eastern oil purchased by the Japanese but delivered to the East or Gulf Coast of the United States, thus achieving a transportation cost saving and a better matching of crude inputs to refining capacity.

A number of U.S. domestic transportation alternatives are being considered including:

1. A proposal by Standard Oil of Ohio (SOHIO) to build a pipeline from the Los Angeles area to West Texas through in part converting 800 miles of an existing natural gas line to oil. Beyond West Texas, the oil would be transported in existing pipelines which are expected to have surplus capacity due to declining oil production in West Texas.

2. A proposed "Northern Tier" pipeline from the State of Washington to Minnesota where it would connect with existing pipelines for Chicago, serving refineries in Montana, North Dakota, and Minnesota, whose existing pipeline connections are with Canada.

3. A number of northern refiners are proposing a pipeline from Kitimat in British Columbia to Edmonton, Alberta. Here it would connect with the Canadian Trans-Provincial Pipeline and the Rangeland Pipeline to Montana. Current existing excess capacity in the Trans-Provincial Pipeline would be used to ship oil to the Northern Tier and Midwestern markets.

4. Use of U. S. flag ships through the Panama Canal to Gulf Coast ports.

5. Use of foreign flag tankers through the Panama Canal to the Virgin Islands for refining there and shipment of product to East Coast ports.

<u>Issues</u>

1. Should the United States Government encourage construction of a pipeline from the West Coast to the eastern United States and, if so, which one or ones?

2. Pending completion of such a pipeline, should oil be exchanged with Japan in the short run or should U.S. flag tankers be used to transport the oil through the Panama Canal? Or should Japanese exchanges constitute a long run solution?

3. Should a Virgin Islands option be chosen?

4. Should any special effort be made to encourage refinery modifications on the West Coast and if so how?

Analysis

1. West-East Pipeline

FEA analysis shows that any of the pipeline routes have lower costs than using the Panama Canal. The Kitimat and SOHIO pipeline routes appear to have the most advantages in relation to costs. However, none of the pipeline routes could be in operation before completion of the Alaskan Pipeline. Thus, the short run decision is likely to be between the use of the Panama Canal and exchanging some of the oil with Japan, which would require Presidential approval and Congressional concurrence.

a. Kitimat Pipeline

The Kitimat pipeline would carry both Indonesian crude destined for the refineries along the border and Alaskan crude destined for U.S. refineries in the Chicago area and elsewhere. It might also be used to transport Alaska oil to markets in eastern Canada in exchange for continued deliveries of Canadian oil to U.S. refineries. This route, being entirely within Canada, requires no U.S. support. Because of the closeness of Kitimat to Alaska, it involves the shortest ocean haul of any of the routes. It appears to have Canadian support and does not appear to involve any significant environmental opposition.

b. SOHIO Pipeline

This proposal is furthest along in terms of planning and would probably be the first pipeline to be constructed if necessary permits are granted. SOHIO has petitioned the Federal Power Commission for abandonment of El Paso's natural gas pipeline and has sought necessary permits to cross Federal lands. In addition, permits will be required, inter alia, from the California Air Resources Board and EPA in connection with air quality in the Los Angeles area. Opposition centers on air quality questions in the Los Angeles area which does not now meet primary air quality standards. If the air quality questions can be resolved, the SOHIO pipeline proposal has much to commend it; but must be assessed in relation to Kitimat. As Alaska oil production builds up, however, a good argument can be made that we will need both a SOHIO and a Kitimat Pipeline.

c. Northern Tier Pipeline

Because Canada is in the process of phasing out crude exports to the United States, Northern Tier pipelines and refineries are faced with a loss of supply, a problem that has caused considerable Congressional concern. Further, because these refineries were designed to process low sulfur Canadian crude, the replacement oil used would likely be Indonesian, and the Alaskan oil transported through the Northern Tier Pipeline would probably go to Chicago and other Midwestern markets where the refineries have been designed to process high sulfur oil. This project appears unlikely to proceed because of high cost, lack of support from any of the refineries that it would serve, and because of local opposition from the State of Washington to becoming an oil port for inland cities.

2. Exchanges *

FEA analysis shows substantial savings in transportation costs through exchanging oil with Japan. These savings are of the order of magnitude of $1 per barrel. The basic reason the potential for savings exist is because of the closeness of Japan to Alaska and the ability to use non-U.S. flag ships in connection with such exchanges. In contrast, direct transport to the eastern United States involves either an across the Rocky Mountain pipeline, or a circuitous routing through the Panama Canal using more expensive U.S. Flag Jones Act tankers.

Security risks from exchanging oil appear minimal. Since the Alaskan pipeline legislation was passed, the International Energy Agreement has been created with the U.S. a member. This provides that the industrialized countries will share oil supplies in the event of a crisis on the basis of consumption and net imports. Under crisis circumstances, if the agreement is implemented, exports would be subtracted under the formula and thus U.S. supplies would be unaffected, at least as a result of Japanese exchanges.

*(Also see Maritime Administration issue paper "West Coast Oil Surplus and U.S. Flag Tankers")

Even in the absence of an IEA, any delivery of oil to Japan through an exchange agreement would be contingent on continued deliveries of Japanese purchased exchange oil to our East and Gulf Coasts at equivalent prices. If Japanese purchased exchange oil were in fact not forthcoming, the United States could retain access to the Alaskan oil. Since any crisis caused by a cutback in oil production is likely to be accompanied by a surplus of tankers on world markets, it should be possible to transport the oil to the parts of the United States in need of it.

The principal risk involves damage to U.S.-Japanese relations that would occur if deliveries of Alaskan oil were discontinued after some years, even if such discontinuance were in response to Japanese failure to continue deliveries of Middle Eastern oil to the United States. In more normal times, there would probably be some foreign relations benefits from increased trade with Japan arising from an exchange agreement. Since Japan would share in the transportation savings, she should welcome such exchanges.

Further, any risk of damaging U.S.-Japanese relations in the event of Middle East curtailment to both countries could be minimized if the exchanges were structured only as a temporary measure pending completion of a pipeline from West to East. With the knowledge that Alaskan oil was only a temporary source of supply, the Japanese would not count on it for long term needs.

Another problem involves U.S. domestic politics. It may be difficult to explain why we are shipping U.S. oil to Japan in exchange for Middle East deliveries. The fact that we would be protected in the event of curtailment might be difficult to put across to the American people.

Finally, using non-U.S. flag tankers for the exchange would undoubtedly bring about political pressure from the maritime unions who would view such exchanges as a subterfuge to avoid Jones Act requirements. Indeed, in this respect, Senator Stevens in Congressional hearings in September asked FEA Deputy Administrator Hill whether Alaska oil shipped to Japan would be on U.S.-flag tankers, and Hill replied that it would be. If oil is shipped to Japan on U.S.-flag tankers the advantageous economics of Japanese exchanges become more marginal. If imports from the Middle East in exchange are required to be carried on U.S. tankers, the economics of such exchanges are likely to become negative.

Transport of Alaskan oil through the Panama Canal on

Jones Act U.S.-flag tankers adds $1.15 per barrel more to the cost of that oil. While there are expected to be sufficient Jones Act tankers or U.S.-flag tankers which could be converted to Jones Act tankers for this purpose, the economics appear to be negative, except as a short term solution pending completion of the west-east pipeline. Commerce can be expected to be the subject of a certain amount of lobbying from maritime interests in favor of using Jones Act tankers through the Canal as a result of its Maritime Administration responsibilities.

3. Virgin Island Option

The Virgin Island option is essentially a means of avoiding the Jones Act requirements to use Jones Act U.S.-flag tankers in the U.S. coastal trade. Transport to and from the Virgin Islands is exempted from Jones Act requirements. On the other hand, proposals have been made to eliminate this exemption. This option could be expected to be vigorously opposed by U.S. maritime interests. Prevention of the use of this route would, however, require new legislation since no governmental approvals are required for Amerada-Hess (the relevant refinery) to buy Alaskan oil and transport it in foreign flag tankers.

4. <u>West Coast Refinery Modifications</u>

In the short term, the economics are negative on converting West Coast refineries to permit them to process Alaska high sulfur crude because of price controls on gasoline and certain other refined products. Without controls, West Coast refinery modification would probably be economic. At some point, it may prove economic for West Coast refineries to increase their capacity to process Alaskan crude. Decontrol of gasoline prices, or controls on Alaskan crude prices to keep its delivered prices sufficiently far below Indonesian prices would accelerate the conversion process.

<u>Schedule</u>

Because of the impending completion of the Alaskan pipeline in mid-1977, resolution of this issue will be among the earliest energy issues facing the new Administration. The ERC commissioned a study under FEA leadership of alternate Alaska crude transportation routes. This study is in the process of being circulated in draft for State comment. It is planned to prepare a decision memorandum for the President based on this study. Most of the alternatives require Federal action. The pipelines require various kinds of Federal permits; non-Jones Act U.S.-flag tankers will have to be converted to Jones Act requirements; exchanges will have to be approved by the DoC after a Presidential finding and Congressional concurrence. If a decision is made to construct a pipeline, an early start is desirable.

ALASKA NATURAL GAS

Background

The Alaska Natural Gas Transportation Act of 1976 requires the Federal Power Commission (FPC) to recommend a system to deliver North Slope natural gas to "Lower 48" States from the three systems which have been proposed and applications for which are now pending before that agency. Hearings have now been completed, and the Administrative Law Judge is expected to transmit his findings (a public document) to FPC by the end of the year. The FPC is then to make its recommendations to the President by May 1, 1977; these recommendations are to be supported by a report explaining the basis of the decision, expected delivery volume, costs, prices, environmental impacts, and other relevant factors, including expected "Lower 48" regional impacts. The Act provides for Federal agencies, States and other interested persons to comment to the President on the FPC recommendation by July 1, 1977. In the same time frame, the Council on Environmental Quality is required to hold hearings on FPC's environmental impact statement. The President is then to decide by September 1 whether a system should be approved and which system. Congress would then have to approve the decision by joint resolution within sixty days. Provisions are made for submittal of new proposals in the event of Congressional inaction.

The three routes proposed are as follows:

a. Arctic Gas proposes an approximately straight line pipeline route from Prudhoe Bay to Chicago. This route would cross Northern Alaska and the Arctic National Wildlife Range. It has thus encountered environmental opposition. This route proceeds through Canada to the McKenzie River Delta gas fields and then south along the McKenzie River, entering the United States in Montana. One leg would then proceed to the Chicago area past a coal gasification site in North Dakota and from Chicago to Pennsylvania. Another leg would leave the main line in Canada to proceed to the West Coast. This project would carry both Canadian and U.S. gas in the Canadian part of the route. By helping to develop Canadian gas, this route would hopefully encourage Canada to continue deliveries of Canadian gas to U.S. markets now dependent on Canadian gas and provide an inducement to achieve greater Canadian flexibility in connection with phasing out Canadian oil to Northern Tier refiners.

b. A second pipeline route proposed by the Northwest Pipeline Company would parallel the existing oil pipeline to the vicinity of Fairbanks and then follow the Alaskan Highway into Canada. This more circuitous route avoids the need to construct new highways and cross the Arctic National Wildlife Range. Once in Canada, this pipeline would connect with existing lines from Canada to the United States permitting deliveries to both the Midwest and West.

c. El Paso has proposed a route roughly paralleling the existing oil pipeline to Valdez. At the Alaska coast, the gas would be liquified and transported by sea to California. By displacement, the gas now being transported from Texas to supply California could be diverted to supply other parts of the United States.

Finally, it should be noted that the legislation contains a provision which may require that gas be delivered both east and west of the Continental Divide. If there is no way around this provision, at least one of the existing gas pipelines will need to be reversed to permit gas deliveries from California to Texas, and hence to other parts of the United States.

Issues

1. Will Alaska natural gas prove economic, whichever route is chosen?

2. If so, which route should be proposed?

3. What, if any, Federal financial assistance should be given to facilitate the chosen project?

4. What Executive Branch studies must be undertaken early to facilitate an informed Presidential decision?

Analysis

1. Is Alaska Gas economic?

Analysis shows that costs of Alaska natural gas projects range from $6 billion to over $20 billion, depending on estimates of cost overruns and construction delays. Most current analysis estimates a cost of $10 billion as being likely and that economic benefits will probably be positive if major cost overruns are avoided. However, because of the possibility of cost overruns or construction delays similar to those encountered on the Alaskan oil pipeline, it cannot be taken for granted that construction of an Alaskan natural gas transportation system is necessarily desirable or that construction of such a system on a "crash basis" is preferable to a more orderly construction schedule.

Normally, it could be argued that the overall economics of any system to transport Alaskan Natural Gas to the "Lower 48" would be determined by the companies involved. The companies would clearly not make the necessary investments if they did not think they could sell the gas delivered in "Lower 48" markets at a profit. However, the companies involved are asking for an "all events tariff" to assure recovery of any costs involved. The companies have in effect asked for a tariff which would cover the possibility of noncompletion of the project and prolonged interruption of service. If such a tariff or a Federal guarantee is in fact provided, market constraints on the project are considerably reduced. Therefore, the Federal Government must undertake the best possible analysis on overall economics.

2. <u>What route?</u>

If it is determined that Alaskan natural gas is economic, the question remains whether the specific route proposed is the least costly one. The Arctic Gas proposal involves direct delivery to final users. The proposed link from the Chicago area to Pennsylvania could be eliminated by diverting Gulf Coast natural gas now going to the Midwest to lines serving the East Coast. The proposed leg to the Western United States could be eliminated by either injecting Alaskan gas into existing Canadian lines for delivery to the West Coast or by diverting West Texas gas going to the Eastern United States to Pacific Coast markets. On the other hand, the cost of the El Paso project might be reduced by delivering some gas to Washington rather than California.

3. <u>What form of financing?</u>

The companies involved may request Government financial guarantees to protect bond holders against the risk of failure to complete the line, a major escalation in cost, or an interruption of deliveries once construction is completed. Assistance can be either in the form of a Federal guarantee which places risk on all taxpayers or in the form of an "all events tariff" which places the risk only on the customers of the natural gas.

4. What studies are needed now?

An Executive Branch update study of the overall economics of Alaskan natural gas transportation is needed. Such a study should analyze costs and benefits of the Alaskan natural gas delivery systems in relation to discount rates, oil prices, cost overruns, construction delays and alternative sources of natural gas supply. In particular, such a study should update construction cost figures and the likelihood of delays.

Schedule

The President will have to make his decision by September 1, 1977. The additional economic analysis needed should be started immediately in the new Administration drawing, as appropriate, on analysis already underway or completed.

OIL COMPANY DIVESTITURE & PETROLEUM MARKETING

PRACTICES LEGISLATION

Background

There was a great deal of discussion of these two issues during the last session of the 94th Congress. Divestiture ivolves questions of both horizontal and vertical divestiture. Horizontal divestiture involves forcing the major oil companies to dispose of their interests in energy industries other than oil and gas, including coal, nuclear power, and geothermal development. Vertical divestiture involves limiting the major oil companies to one level of the oil industry, for example, production, refining, pipelining or marketing. The proposed Petroleum Industry Competition Act of 1976 (S. 2387) would have reorganized the petroleum industry by requiring that the assets of the 18 largest U.S. vertically integrated oil companies be divided into separately owned and controlled production, transportation, refining and marketing segments.

In addition, the Congress considered proposals such as the Petroleum Marketing Practices Act (H.R. 13000) to regulate the marketing practices of the major petroleum companies. Early versions of the bill would have prevented major companies from increasing the volume of gasoline that they sold through service stations they themselves operated. Later versions of the bill were limited to preventing arbitrary cancellation or failure to renew service station leases or franchises.

Issues

1. Is horizontal divestiture desirable?

2. Is vertical divestiture desirable?

3. Would some type of petroleum marketing legislation be desirable?

Analysis

1. Horizontal Divestiture

Proponents of horizontal divestiture argue that control of, say, coal and/or nuclear companies by the major oil companies reduces competition between fuels. Opponents of such horizontal divestiture argue that oil company capital flowing into coal or nuclear power companies makes a useful contribution to developing these resources and provides additional competition within those industries. It is also argued that if petroleum companies are forbidden to own coal resources they will have only limited incentive to do research on coal gasification or liquifaction, thus reducing the chance of these technologies being commercialized. From the viewpoint of the investor in such companies, it is argued that being in several energy industries provides additional diversification and makes it possible to employ the capital resources of a firm in whatever part of the industry that provides the highest return. A final argument is that any horizontal divestiture program would involve some disruption of general operations and impose unnecessary cost in money and management time in dealing with lengthy and costly litigation.

2. Vertical Divestiture

Proponents of vertical divestiture argue that vertical control reduces competition. For example, pipeline control may prevent competition in refining and marketing, and control of foreign oil may create difficulties for non-integrated refining firms. Marketing firms frequently find themselves in the position of buying the product they sell (for example, gasoline) from a firm that also serves some customers directly. This has led to frequent complaints that the independent operators are being "squeezed." In addition, some simply feel that the major oil companies are too large.

Arguments against vertical divestiture include the fact that the current system results in economies. If is further argued that refineries and pipelines can be better designed if the quality and quantity of crude to be processed are known in advance. It is further argued that vertical divestiture would go far beyond current anti-trust law, involve reorganization of well over $100 billion of assets, demand thousands of man hours of top management and professional attention, and dramatically increase investor uncertainty. It would do this at a time when the oil companies' management and capital resources should be focused on the achievement of reduced energy vulnerability. From the point of view of improving our bargaining power vis-a-vis the OPEC cartel, vertical divestiture would tend to weaken the set of parties on our side of the transaction.

Further, concentration levels in the refining and marketing areas of the petroleum industry have not changed significantly in the last twenty years. For the largest eight firms, concentration ratios for both refinery capacity and gasoline marketing declined by 1% between 1955 and 1974. Concentration levels for petroleum refining are less than the average for all U.S. manufacturing, and new entry and expansion by independent refiners has been appreciable over the last 15 years. From the point of view of profits, petroleum firms have experienced an after tax return on net worth comparable to that found in other industries, and less than that of the chemical, drug and health related industries. In the period 1965-72 the average return on net worth for the 18 largest U.S. based petroleum companies was 11.9% vs 12.4% for all industries excluding petroleum.

The consumer will normally benefit from vertical integration because profit margins at each stage can be reduced. For instance, a service station operator wishing to achieve a small increase in volume will realize only the profits from the retailing stage of the operation. A vertically integrated firm making the same decision can look forward to increased volume for its retail, wholesale, product transportation, refining, and crude transportation operations. The result will frequently be that an integrated firm will decide to reduce prices when a chain of separate firms would not. On the other hand, the greater incentive to cut prices is what causes independents to feel that they are being squeezed.

3. <u>Petroleum Marketing Practices</u>

The attempts to prevent petroleum companies from operating their own gasoline stations in order to protect small operators and limit their ability to cancel independent operators' leases or franchises are all aimed at assuring competition at the retail level and protecting small businessmen at a time when some retrenchment at the retail level is inevitable.

As noted above, vertically integrated service station operations can result in lower prices to the consumer. As a practical matter, oil companies do not appear to eliminate independent service station operators in favor of company owned stations; independent station operators have proved themselves as having a greater incentive to produce good results.

<u>Schedule</u>

Both vertical divestiture and petroleum marketing practices legislation are expected to be introduced into the first session of the 95th Congress.