

BY THE U.S. GENERAL ACCOUNTING OFFICE

# Report To Senator Howard M. Metzenbaum

## Determination Of Oil Price In The International Emergency Sharing System-- An Unresolved Issue

Countries have become increasingly concerned over how to determine the price of oil that would be shared in an international emergency. However, they have been unable to agree on how pricing considerations could be included in a test of the international oil sharing system.

The United States has taken the position that testing price in an artificial environment could establish false pricing standards that might compromise the effectiveness of the system for an actual emergency. Some other countries have contended that the inability to integrate the pricing element into the test underscores the difficulties that may occur in an emergency.

Regardless of whether the pricing element is included in test, underlying differences remain between the United States and other countries on pricing principles to be used in an emergency. These differences should be resolved to minimize the problems that might be encountered if and when the Emergency Sharing System is activated.



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GAO/ID-83-15  
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UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

INTERNATIONAL DIVISION

B-203093

The Honorable Howard M. Metzenbaum  
United States Senate

Subject: Determination of Oil Price in  
the International Emergency  
Sharing System--An Unresolved  
Issue (GAO/ID-83-15)

Dear Senator Metzenbaum:

In response to your September 30, 1982, request (see app. I), we are reviewing several different aspects of U.S. participation in the International Energy Agency (IEA). This report responds to your specific request for information on U.S. involvement in the fourth test of the IEA Emergency Sharing System scheduled for the spring of 1983 and addresses the major issue of pricing considerations. Although price considerations are generally regarded as an integral part of the allocation system, the United States and other IEA member nations to date have been unable to agree on how pricing considerations could be included in a test. Some countries believe this underscores the difficulties that may occur in the event of an actual emergency.

The United States has taken the position that testing prices in an artificial environment could establish false pricing standards that might compromise the effectiveness of the system for an actual emergency.

Regardless of whether the pricing element is included in the test, underlying differences remain between the United States and other countries on pricing principles to be used in an emergency. These differences should be resolved to minimize the problems that might be encountered if and when the Emergency Sharing System is activated.

BACKGROUND

The process of reallocating oil supplies in an emergency is a complex exercise. IEA members have become increasingly concerned over how to determine the price of oil that would be shared

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in an international emergency situation. All tests of the IEA Emergency Sharing System to date have only included volumetric exercises. Factors that determine the price at which oil is traded were not incorporated.

Past tests were designed to develop and upgrade the mechanics of the system; they provided valuable training experience for participants and insights into data requirements, as well as opportunities for assessing the effectiveness of emergency procedures, communications, and national emergency management programs. Each test typically took place over a 4 to 8 week period at IEA headquarters and involved representatives of national governments, oil companies, and the IEA Secretariat. Disruption scenarios were constructed and historical oil company information was used as the basis for operation. Although allocation rights and obligations were assessed, actual diversion of supplies did not take place. In essence, the tests were simulations.

Many observers criticized these tests as being unrealistic on the basis that there was no determination of the price at which oil was to change hands. Our September 8, 1981, report reflects this concern over the failure to include pricing in emergency sharing tests. 1/ In addition, the IEA Secretariat and many IEA member governments and oil companies, particularly foreign ones, felt that integrating the transfer price component would enhance the value of the emergency allocation test. Some contended that failure to include price in subsequent tests would cast considerable doubt over the viability of the Emergency Sharing System in an actual emergency.

In the wake of the third test in the fall of 1980, all IEA members agreed to consider the feasibility of integrating price into the 1983 test in order to (1) assess the nature and extent of delays which might be caused in the reallocation process due to pricing negotiations between buyers and sellers, (2) evaluate the extent to which voluntary offers of oil were not made or accepted due to inability to agree on price, and (3) assess the extent to which pricing considerations affected the ability to allocate oil between countries.

#### FAILURE TO AGREE ON PRICING APPROACH

Disagreement over the feasibility of testing oil pricing has been a major problem in preparing for the 1983 Emergency Sharing

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1/ Unresolved Issues Remain Concerning U.S. Participation in the International Energy Agency (ID-81-38).

System test. Even a proposed compromise by the IEA Secretariat for a limited test has failed to overcome objections by some participating countries and oil companies.

In December 1981, the IEA established a test Design Group composed of several government, oil industry, and IEA Secretariat officials, with the United States as Chairman, to develop procedures for the forthcoming Emergency Sharing System test. The feasibility of testing price has been the dominant concern of the Design Group in its four meetings over the past year. The Design Group commissioned a technical subgroup, also chaired by the United States, to intensively study the pricing issue and to develop an approach acceptable to IEA members for testing price. After considering possible approaches ranging from a totally free market approach to a completely regulated method, the subgroup members agreed to advance a market-oriented proposal with certain limitations.

The Design Group considered the subgroup proposal in a June 1982 meeting. After considerable discussion, Design Group members were unable to reach a consensus. Some members supported the proposed mechanism as a simple and workable approach, while others felt it did not adequately reflect a market approach. Nevertheless, the Design Group advanced the proposal with appropriate qualifying remarks to the IEA's Standing Group on Emergency Questions, which was established by the IEA Governing Board and is responsible for emergency sharing decisions. The Design Group asked for further guidance and urged that the Standing Group promptly address the issue of oil pricing principles for an actual emergency.

The Standing Group on Emergency Questions met in June 1982 and reviewed the Design Group's comments and conclusions on testing price. In that meeting, the majority of IEA governments and oil companies:

- Supported the inclusion of price in the forthcoming test on the grounds that price resolution in an emergency was perhaps the critical problem that must be confronted.
- Indicated that, without some understanding of how oil prices would be determined in a crisis, it would be very difficult if not impossible to allocate oil.
- Contended that participating governments and oil companies could gain considerable useful information on price behavior in an emergency situation as well as experience in negotiating and resolving price differences.

--Believed it would be beneficial to obtain a sense of the impact of including price in the emergency allocation process on the entire IEA emergency system as well as on member countries' domestic emergency systems.

However, due to considerable opposition by the U.S. Government, several U.S. oil companies, and the West German Government, the Standing Group on Emergency Questions was unable to reach a consensus on the mechanism for testing price. Instead, as an interim measure, it approved a Secretariat suggestion to draft a compromise proposal in hopes of obtaining a consensus among member nations.

The Secretariat pricing proposal was completed in July and reviewed by the test Design Group in September 1982. This proposal called for the pricing components to be separated from the overall test, and a special technical expert group to evaluate pricing information that was reported. It excluded any procedures for negotiating prices and resolving price disputes and provided no formula for determining price. The Design Group did not concur in the Secretariat's compromise because:

1. Reported price information would not adequately reflect price behavior in an emergency.
2. Buyer and seller would not negotiate price; but rather price assumptions would have to be used.
3. Results from a test using limited pricing data could be misinterpreted in the development of policy

In rejecting the Secretariat proposal, the Design Group stated that its June 1982 report was still operative and that it was awaiting further guidance from the Standing Group on Emergency Questions.

Because no consensus had been reached, the Standing Group on October 25, 1982, recommended that the upcoming test proceed without the integration of pricing elements. However, as a compromise, an IEA Secretariat proposal was adopted by all IEA members which called for (1) an independent group of experts to follow the test and provide an appraisal of factors that might facilitate the functioning of the Emergency Sharing System, (2) oil company and national representatives to give serious consideration to how to make the system work more effectively, (3) the Design Group to study the usefulness of providing a set of assumed market conditions for the experts as well as company and national representatives, and (4) the

development of mechanisms to transmit price data. The Governing Board agreed with the recommendation. It should be noted, however, that pertinent pricing data would not be exchanged or analyzed.

#### U.S. POSITION

As indicated earlier, the United States as well as West Germany opposed the inclusion of price considerations in the upcoming test on the basis that price behavior in a test would provide no useful information or experience applicable to an actual energy emergency. In fact, the U.S. delegation stated that testing of price in an artificial environment could establish false pricing standards for an actual emergency that might compromise the effectiveness of the Emergency Sharing System. It also contended that technical problems associated with simulating price negotiations would seriously impede successful testing of price. More recently, U.S. Government officials and representatives of several U.S. oil companies have emphasized that unless members of the IEA agree on pricing principles for use in an actual emergency, consideration of price in the next test would not be appropriate or useful.

The U.S. position on testing price appears to have emerged out of meetings of the Interagency Group on International Energy Policy, composed of officials at the assistant secretary level. Representation includes the Department of State, which provides the Group's chairman; the Departments of Energy, Justice, Defense, Commerce, and Treasury; and the Office of Management and Budget. It is our understanding that this Group's decision was made on a consensual basis only after extensive discussions and debate.

In September 1982, the U.S. delegation announced that the U.S. Government opposed any inclusion of pricing in a full test or in the more limited one proposed by the Secretariat in July. The U.S. delegation explained that this position was taken for a variety of reasons, including (1) the conviction that the testing of price would proceed more expeditiously and effectively if uniform pricing principles were more clearly established by IEA member nations, (2) the serious technical problems associated with simulating price negotiations have not been resolved, and (3) considerable doubt exists that company negotiating behavior in a test would be a reliable indicator of behavior in an actual emergency.

The State Department has further explained that in the event of an actual activation of the IEA allocation system, the system managers at IEA headquarters would match oil and receive offers volunteered primarily by oil companies and would inform affected parties of the proposed transactions and leave those parties to negotiate terms, including price, between themselves. The State Department maintains that simulation of this process in a test might prove unrealistic because with no money actually changing hands, it could not be certain that companies' negotiating behavior in the test would accurately mirror their behavior if money were at stake.

U.S. officials have repeatedly expressed concerns about (1) the viability of an Emergency Sharing System test complicated by artificial price scenarios, (2) the usefulness and reliability of conclusions flowing from such a test, and (3) the additional burden that inclusion of price would impose on participating governments and companies and on the IEA Secretariat.

The majority of IEA participating governments and those oil companies that support price testing argue that such a test is no more unrealistic than the testing of other Emergency Sharing System elements which is supported by the U.S. Government as informative and useful in preparation for an actual emergency; i.e., if company behavior might be questionable in resolving pricing matters why would their test behavior in non-pricing matters be any less questionable? In essence, these parties maintain that the test of the Emergency Sharing System is an important contingency planning exercise that is predicated on the belief that all participating parties will attempt to conduct themselves in a responsible manner consistent with their expected behavior in an actual emergency. They also reiterate that if price cannot be incorporated in a test, the difficulty in responding to the pricing issue in a real emergency may well hinder if not cripple the allocation process. Additionally, the IEA Secretariat and most participating oil companies have expressed no major concerns about the burden of testing price.

The primary pricing concern of the United States focuses on what is perceived to be a conflict between the language in the International Energy Program Agreement and in the IEA Emergency Management Manual. According to the Agreement, the objectives of the Program shall include fair treatment for all participating countries and the price of allocated oil shall be based on the price conditions prevailing for comparable commercial transactions. This is generally interpreted to mean that the free market will establish the price of allocated oil. However, the Emergency Management Manual calls for oil to be allocated at term and not spot prices. <sup>1/</sup> This is of concern to many U.S. private oil companies, which believe that in an emergency short-supply situation most oil traded will be at high spot-market prices. These companies believe that the current Emergency Management Manual language unrealistically implies that oil companies might sell oil at prices less than those indicated as comparable commercial transactions under the Agreement.

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<sup>1/</sup> Spot prices refer to the price of oil not under contract and which can fluctuate on a daily basis; term prices refer to contractual prices that generally remain constant for a longer duration.

U.S. Government officials are concerned that restricting allocated oil prices in an emergency to term prices would be inconsistent with the free market orientation of the Agreement and the thrust of U.S. energy policy. Therefore, since the summer of 1981, the United States has been requesting a full review of this issue within the IEA. The U.S. Government and U.S. private oil companies discussed this issue with the IEA Secretariat and its Standing Group on Emergency Questions, but to date no resolution has been reached.

Many other member governments view the pricing principle issue as being an independent matter. They further explain that the inclusion of price considerations in a test is generally a procedural issue that would provide valuable training and experience regardless of the pricing principle employed. They contend that a meaningful test of price can and should be conducted. Some of these countries also oppose the shift to spot pricing in an actual emergency on the grounds that spot prices would substantially raise their crude oil prices, so they continue to support the use of term prices in an allocation emergency.

In terms of testing price in next year's exercise, the Design Group left the issue open by agreeing to separate the issue of pricing principles in an emergency from the testing of price in the overall emergency system's test. It decided to go forward with efforts to develop a mechanism for testing price without resolving the pricing principles issue. Recently, U.S. Government officials, particularly those at the Department of Energy, attempted to tie the issues together and to make the resolution of pricing principles a prerequisite to testing of price next year. However, critics conversely argue that the testing of price using various assumptions could (1) enhance the participants' understanding of the effects of price on the operations of the emergency allocation system and (2) facilitate a consensus as to pricing principles to be used in an actual emergency.

In June 1982, the Standing Group on Emergency Questions refused to consider the pricing principles issue despite strong urging from the U.S. Government delegation. Instead, its chairman postponed consideration of the issue until December 1982.

#### AGENCY VIEWS

The State Department informed us that, in its opinion, the IEA emergency oil allocation system can function successfully only if oil traded under the system is priced at market levels. The Department stated that oil company participation in the system is voluntary and that it was unrealistic to expect companies to sell oil at below-market levels. Moreover, it emphasized that no country with an allocation obligation under the system could hope to uphold politically a decision to sell oil in a short-supply situation to another country at a price below that of other oil supplies.

According to the State Department, the IEA system is designed to guarantee member countries access to essential volumes of oil in a crisis, not as a substitute for allocation of oil by the marketplace or as a channel of foreign aid. (See app. II.)

The Department of Energy holds the position that if the IEA relies on market prices in an emergency, companies would be able to recover the marginal costs for oil offered voluntarily. It maintains that if companies perceive that they will not be required to sell oil at less than commercial terms, they may be more willing to participate in the system and thus facilitate its operation. (See app. III.)

#### SUMMARY

Many IEA member governments and oil companies as well as the IEA Secretariat believe that the determination of price in an emergency using a market-oriented system is preferable. However, there is no agreement as to actual practices to implement this policy. The Emergency Sharing System provides for government intervention and directed allocation of oil supplies in the event voluntary sharing proves unworkable. Thus, a failure to resolve price disputes in an actual emergency could lead to government-directed allocation of oil.

The price of oil in an international emergency is important to the effective distribution of oil supplies among consuming countries. If the 21 IEA member countries that would be called upon to allocate oil in a severe disruption cannot agree on a pricing approach, serious questions could be raised about the viability of the IEA Emergency Sharing System in an actual emergency. The majority of IEA governments and oil companies as well as the IEA Secretariat supported the inclusion of price considerations in the forthcoming test on the basis that price determination and resolution in an emergency is an important issue that member nations must confront. Also, they contend that considerable useful information and experience concerning the behavior of price and necessary government and industry responses could be gained. The U.S. and West German Governments disagree, and without a consensus, pricing considerations will not be included in a test.

Regardless of whether the pricing element is included in the test, underlying differences remain between the United States and other countries on pricing principles to be used in an emergency. These differences should be resolved to minimize the problems that might be encountered if and when the emergency system is activated.

SCOPE AND METHODOLOGY

Our audit work was conducted in accordance with generally accepted government auditing standards. Information in this report was developed through documents from and interviews with U.S. Government and oil company officials, foreign government and oil company officials, and IEA Secretariat officials over the past several months. We also attended meetings of the IEA Industry Advisory Board, AST-4 Design Group, and Standing Group on Emergency Questions. The Departments of State and Energy also provided written comments on specific issues concerning the inclusion of pricing considerations in the upcoming test.

As arranged with your office, no further distribution of this report will be made for 5 days from the date of issue unless you publicly announce its contents earlier.

Sincerely,



Frank C. Conahan  
Director



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## United States Senate

COMMITTEE ON THE JUDICIARY  
 WASHINGTON, D.C. 20510

September 30, 1982

Mr. Charles A. Bowsher  
 Comptroller General of the United States  
 441 G. Street, N. W.  
 Washington, D. C. 20548

Dear Mr. Bowsher:

The Senate Committee on Energy and Natural Resources at my request is planning to conduct extensive hearings in the next session of Congress on all issues related to United States participation in the International Energy Agency. In preparation for those hearings, I would like the General Accounting Office to follow up on issues identified as being unresolved in your September, 1981 report on United States participation in the IEA.

I would like GAO to address specifically the following additional issues: (1) U.S. involvement in the IEA's fourth test of its emergency sharing system to be held in the spring of 1983; (2) IEA member country policies and procedures for dealing with pricing of oil in an emergency; (3) the relationship between the IEA emergency sharing system and similar European Economic Community and North Atlantic Treaty Organization petroleum emergency allocation programs; (4) IEA member country policies for and programs to manage and coordinate oil stocks in an emergency; (5) the quality of the IEA Emergency Data System; (6) the responsibility for management of U.S. participation in the IEA; (7) the extent of oil industry involvement in the above activities; and (8) the status of the IEP requirement to conduct a general review of the International Energy Program.

I would like the GAO to monitor as many IEA industry and government meetings as practicable in the coming months in addition to contacting governmental, industry, and IEA secretariat personnel. The GAO should be prepared to testify at next year's hearings, provide me with a comprehensive follow-up report, and brief my staff on a regular basis.

Once again, I would like to take this opportunity to thank your staff for their continuous high quality assistance on this issue. Their efforts have been extremely helpful in providing the committee and the Congress with independent and objective information and analysis.

Sincerely yours



Howard M. Metzenbaum  
 United States Senator



## DEPARTMENT OF STATE

Washington, D.C. 20520

Mr. Allan I. Mendelowitz  
Associate Director  
United States General Accounting Office  
Washington, DC 20548

Dear Mr. Mendelowitz:

Thank you for your letter of August 20 to E. Allan Wendt inquiring about consideration of inclusion of oil pricing issues in the fourth test of the International Energy Agency's allocation system (AST-4). Mr. Wendt is out of town, so I shall attempt to respond to your questions.

1. Please describe the methodology developed by the IEA Technical Subgroup to test pricing and the United States' assessment of its strengths and weaknesses.

To date, the AST-4 Design Group has focussed its attention primarily on what guidelines to use for pricing simulated oil transactions under the IEA allocation system during AST-4. Having attended the June meetings of the Design Group and of the Standing Group on Emergency Questions (SEQ), Phillip J. Thomas of your staff has received copies of the relevant working papers and is familiar with the status of deliberations on this subject.

The Design Group has thus far reached no conclusions as to the methodology for including price in AST-4. The Secretariat proposal to be discussed at the September 23-24 Design Group to which you refer on page 2 of your letter contains some discussion of this issue and we are currently studying it.

As you note, the U.S. delegations to the June meetings of the Design Group and SEQ opposed inclusion of price in AST-4. In light of the discussions there, and of the new Secretariat proposal, we are now reviewing this position. We will not be able to comment authoritatively on the merits of the various proposals relating to pricing until this review is complete.

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2. What is the explanation for U.S. Government opposition to the testing of price in next year's IEA Emergency Sharing test?

As noted above, the Administration is currently reviewing its position on inclusion of pricing in AST-4 in preparation for the September 23-24 Design Group meeting. We based our opposition to inclusion at the time of the June meetings primarily on concerns about (1) the viability of a test complicated by artificial price scenarios; (2) the usefulness and reliability of conclusions flowing from such a test; (3) the additional burden which inclusion of price would impose on companies, governments, and the IEA Secretariat participating in the test.

3. Why would a test of price be more unrealistic than a test of the other Emergency Sharing System elements which the United States continues to support as informative and useful in preparation for an actual emergency?

In the event of actual activation of the IEA allocation system, the system managers in Paris will match oil supply and receive offers volunteered primarily by oil companies, inform affected parties of the proposed transactions, and leave those parties to negotiate the terms of the transaction, including price, between themselves. Simulation of this process in AST-4 might prove unrealistic only to the extent that, with no money actually changing hands, we could not be certain that companies' negotiating behavior in the test would accurately mirror their behavior if money were at stake.

4. Why did the U.S. Government agree to chair the Technical Subgroup and participate in developing a mechanism for testing price in the forthcoming test if it opposes the testing of price?

The United States did not seek the chairmanship of the Design Group; we were drafted by the other members of the SEQ. IEA members had agreed early in 1981, based upon their experience with AST-3, that we would seriously consider including price in AST-4. This was duly incorporated as one, although by no means the only, objective of the Design Group in the terms of reference established for the Group at its creation last December. Our ability to manage the work of the Design Group in preparing the diverse elements of AST-4 is in no way affected by the U.S. position on the single issue of including price in the test.

- 3 -

5. If there are no pricing tests and it is anticipated that the IEA emergency sharing system in actual operation will rely on a market-oriented pricing policy, what would be the impact on the operation of the Emergency Sharing System and, the distribution of oil supplies?

In our view, the IEA emergency oil allocation system can function successfully only if oil traded under the system is priced at market levels. Oil company participation in the system is voluntary. It is unrealistic to expect companies to volunteer to sell oil at below market levels. Moreover, no country with an allocation obligation under the system could hope to uphold politically a decision to sell oil in short supply to another country at a price below that of other oil supplies. The IEA system is designed to guarantee IEA member countries access to essential volumes of oil in a crisis, not as a substitute for allocation of oil by the marketplace or as a channel for foreign aid.

I hope you find this information helpful.

Sincerely,



John P. Ferriter  
Acting Deputy Assistant  
Secretary for  
International Energy Policy



Department of Energy  
Washington, D.C. 20585

SEP 13 1982

Mr. Allan I. Mendelowitz  
Associate Director  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. Mendelowitz:

This letter responds to your request for information regarding the testing of price in the fourth International Energy Agency (IEA) Allocation Systems Test (AST-4).

Our written answers to your questions are enclosed.

Sincerely,

A handwritten signature in black ink, appearing to read "H. E. Thomas".

Henry E. Thomas  
Assistant Secretary for  
International Affairs

Enclosure

**Question 1:** Please describe the methodology developed by the IEA Technical Subgroup to test pricing and the United States' assessment of its strengths and weaknesses.

**Answer 1:** The AST-4 Design Group has not developed a methodology to date. The Group has reached no consensus on whether to include price in AST-4 or on what pricing standards or guidelines should be tested.

A special price sub-group of the full Design Group was convened in May to address the pricing standards question. The sub-group concluded that it generally preferred the guidelines proposed by the IEA's Industry Advisory Board (which entail a revision to the existing language of the Emergency Management Manual to make it more consistent with that in the IEP), but also noted certain practical problems associated with their use in AST-4.

The IEA Secretariat has advanced a proposal for a more limited study of price in AST-4, short of a full price test. This proposal is now under review in the Administration.

**Question 2:** What is the explanation for U.S. Government opposition to the testing of price in next year's IEA Emergency Sharing test?

**Answer 2:** The U.S. Government is concerned that no clear consensus has emerged within the IEA on pricing standards either for the test or for an actual emergency. At the June meeting of the IEA Standing Group on Emergency Questions, the U.S. agreed to examine the IEA Secretariat's proposal for inclusion of price in AST-4. This proposal, and any others, will be debated at the next Design Group meeting.

**Question 3:** Why should a test of price be more unrealistic than a test of the other Emergency Sharing System elements which the United States continues to support as informative and useful in preparation for an actual emergency.

Answer 3: The tests of the Emergency Sharing System were designed to fine-tune the mechanics of the System in the event it was ever activated for an oil supply disruption. The process of reallocating oil supplies is a complex exercise. These tests, although paper exercises, provide valuable training experience to participants, both companies and governments, in the mechanics of the sharing process and data requirements.

The IEA system is designed so that, ideally, prices of voluntary offers will be directly negotiated between contracting parties with no interference from the IEA or governments. This negotiating process between parties is particularly difficult to test with any modicum of commercial realism.

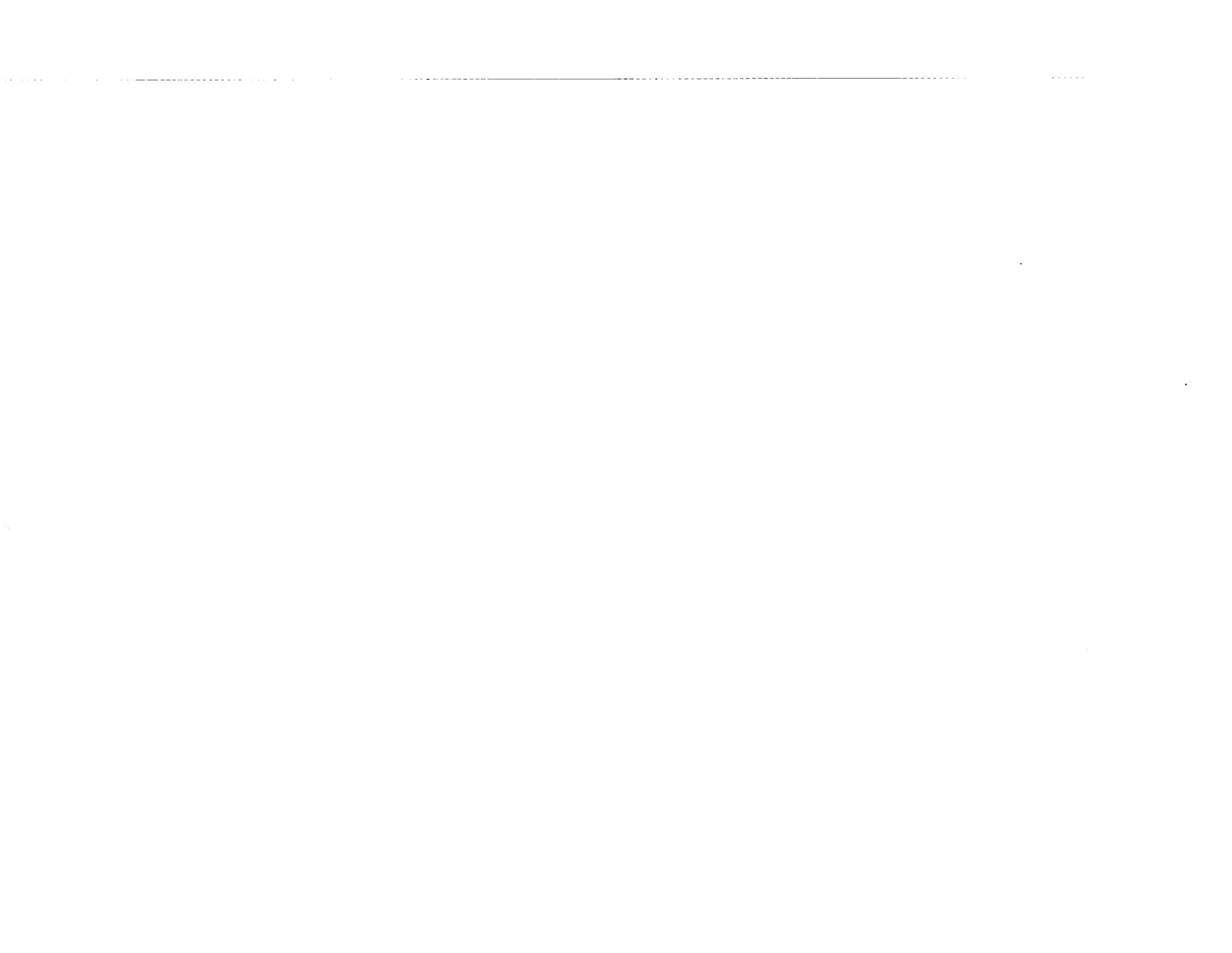
Question 4: Why did the U.S. Government agree to chair the Technical Subgroup and participate in developing a mechanism for testing price in the forthcoming test if it opposes the testing of price?

Answer 4: The U.S. Government agreed to chair the Technical subgroup at the request of the Chairman of the Standing Group on Emergency Questions. This position provides us the opportunity to bring our expertise to bear on the pricing issue, focus the discussion on the precise needs of AST-4, and contribute to our overall leadership efforts in the IEA.

Question 5: If there are no pricing tests and it is anticipated that the IEA Emergency Sharing System in actual operation will rely on a market-oriented pricing policy, what would be the impact on the operation of the System and the distribution of oil supplies?

Answer 5: If the IEA relies on market prices, companies would be able to recover the marginal costs for oil offered voluntarily. If companies perceive that implementation of the sharing system will not require them to sell oil at less than commercial terms, they may be more willing to participate in the program. Thus, the impact on the system will be to facilitate its operation.





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