CHAPTER VIII

THE INTERNATIONAL OIL CRISIS

Background

The international oil crisis is the result of conflicting interests of producing countries and international oil companies over the production of crude oil and the price at which it is sold. In order to understand the full significance of the present development it is necessary to know the history of the relationship between the oil producing countries and the oil companies.

One of the distinguishing features of the international oil industry is that the crude oil is available only in a few countries in the world. Except U.S.A., U.S.S.R. and other communist countries, there are 13 countries which are the members of the "Organization of Petroleum Exporting Countries," supplying petroleum to the world. Most of these countries are in the Middle East and North Africa.

Oil Companies

The production of oil and marketing it is in the hands of a small number of very big oil companies mostly owned by
Americans and British. They can be grouped into two categories international majors and independents. Out of the seven big international oil companies, five are American and two are British. These seven big companies are:

(1) Standard Oil, New Jersey (U.S.A.)
(2) Mobil Oil
(3) Texas Oil
(4) Gulf Oil
(5) Standard Oil of California
(6) Royal Dutch/Shell (U.K.)
(7) British Petroleum

Recently an eighth company Compagnie Francaise des Petroles (CFP) is added to this list.

Besides these major oil companies, there are also about 30 independent and national oil companies which are set up by the oil producing countries recently and a number of smaller companies which have entered the industry in the last two decades. The foreign oil companies have entered into concession agreements with the producing countries for the production of crude oil and marketing it.

The major companies which dominate the international oil industry are highly integrated from the stage of
production of crude to the marketing of finished petroleum products. They own their requirements of crude. Control transport facilities, own their refineries and have their distribution outlets all over the world. These companies produced in 1969 nearly 80 per cent of the oil in the world outside the communist countries and North America. They also controlled 70 per cent of the refining capacity outside U.S.A. and communist countries. These seven groups of companies are also associated with one another through joint ventures and joint ownership of subsidiaries. These companies had also some sort of understanding regarding the price at which they sold their crude before second world war. But these companies are also in competition with one another. The competition is the non-price competition namely improvement in product, service and advertisement etc. The price competition is prevented because of the cartel arrangement among themselves and the prevalence of the system of posted prices.

**Posted Prices**

It is very interesting to know how this system of

posted price came into existence in the Middle East which now happens to be the dominant crude producing area in the world. Before the second World War the Middle East was not an important producer of crude. That time the Gulf of Mexico- Caribbean area was the dominant supply source for World Market. In 1939 Middle East was supplying only 5 per cent of total world oil production. The exports were limited to countries very near to the region and to Western Europe. Since Middle East crude was produced by the big international oil companies who were also operating in the U.S.A., the Middle East crude was sold in Europe at a price which equated the laid down cost of this crude to the refineries in Europe with the laid down cost of similar crude from Western Hemisphere sources. This is called "the single basing point system." According to this system Middle East crude was sold as if it was being shipped from U.S. Gulf. The Middle East had a freight advantage for delivery to the east of Suez and the Eastern Mediterranean area. Therefore, the suppliers to these areas got a higher return. To the west of Suez the returns were low. The point of equal cost was considered to be some point in South Italy.

Since the international oil companies were highly integrated from the stage of crude oil production to marketing, the price at which oil is transferred from one stage to another in an integrated company had only an accounting significance. It did not really matter from the point of view of the overall profitability of the concern whether it showed profits at the stage of production of crude or refining or transport or marketing. But these companies preferred to show more profits at the stage of crude oil production rather than at the stage of refining or marketing because it was advantageous for them for a number of reasons. Firstly when they sell crude to outsiders, they get a higher profit. Secondly high price of crude will increase the cost to independent refiners without affecting the integrated companies and put the independent refiners at a disadvantage vis-à-vis the integrated oil companies. Thirdly the price of crude oil in the Middle East should have some relation to the price of crude from the Western Hemisphere where the cost of production was much higher. The major oil companies had an interest there also.

---

But later on the single basing point system began to weaken because of two factors.

(1) The scrutiny of the government purchasing agencies during the war and the change in the export pattern of Middle East oil. Before the second World War the bulk of the Middle East crude went to European countries, where the net returns to Middle East crude was less than that on US Gulf price because of the greater transport cost due to payment of toll for passing through the Suez canal. This was of course compensated by a higher realisation on sales to countries East of Suez. But during the war Middle East oil was sold mainly in areas where the net return was much higher, on the basis of Gulf plus. When this practice was questioned by government purchasing agencies this had to be given up.

(2) The entry of smaller oil companies into the business of crude oil production in the Middle East: A number of independent oil companies had a considerable success in the exploration for oil in many countries in the Middle East in the forties. Since these companies were not integrated oil companies they lacked sufficient market outlet, for their crude outside U.S.A. and therefore started selling crude at a lower price. The result of all
this was a complete break up of the Gulf plus pricing in the year 1944. 4

With the break up of the single basing point the Persian Gulf became a second basing point and the level of prices in the Persian Gulf were fixed on par with the prices in the U.S. Gulf even though the cost of production in the Middle East was considerably lower than that in the Western Hemisphere. This high crude oil prices resulted in high earnings on production. The integrated oil companies have used this high earnings to finance exploration and development. By spending more money on exploration and development the oil companies could diversify their sources of crude so that they can reduce their dependence on politically unpredictable sources.

The U.S. government also gave certain tax concessions to U.S. oil companies which are engaged in exploration and development within the country as well as outside the country for reasons of security. The oil companies took advantage of this concession to increase their reserves of oil as well as to reduce their tax obligations to the U.S.

The U.S. government's favourable tax treatment for oil exploration and development included allowing losses, dry holes, and intangibles i.e. the cost of development not embodied in salvageable equipment. It also gave "depletion allowance" against tax in respect of wasting oil reserves in the ground. This is at 27½ per cent of gross producing income or 50 per cent of producing income whichever is less. This tax concession combined with high level of prices, gave the oil companies huge profits. No importing country either U.S. or any western oil importing country objected to this high price of crude. In the case of U.S. both the oil companies and government favoured higher price for the Middle East crude. The oil companies favoured a higher price for Middle East crude not only because it gave them higher profits on their Middle East investments, but also because it helped them protect their investments in oil in the U.S.A. Because the U.S.A. has been an oil importer since 1948, the U.S. government also wanted to protect the domestic oil industry from foreign competition for reasons of security.

Similarly other oil importing countries in Western Europe like U.K., Netherlands and France are home countries of international oil companies. Their international payments position benefitted more from high prices than from
low prices. High prices of oil also gave protection to
domestic energy producing industries in some of the
countries like U.K., Germany, France and Belgium.\textsuperscript{5}

Formation of OPEC

Later on certain developments took place which changed
the payment by the oil companies to host governments. The
U.S. tax laws permitted foreign tax payments to be treated
as full tax credits against U.S. income taxes. This used
to be treated as a cost item earlier. The oil companies,
in order to take benefit from this change in U.S. tax laws
changed payments to host government from flat royalty to an
income tax calculated on the basis of posted prices. By
1954 all major oil producing countries in the Middle East
were on 50:50 profit sharing basis. When the mode of pay­
ment changed to profit sharing the producing countries
acquired direct interest in high prices. Till then they were
not bothered about the prices because the royalty was based
on the quantity of crude produced and had no relevance to
the price at which it was sold. At the same time there was
increasing competition between established majors and new

\textsuperscript{5} Frank H.J., op.cit.
entrants to sell crude oil. We have already seen that a number of smaller companies had entered into exploration in many countries in the Middle East. They achieved success in exploration. By the time these companies achieved success in exploration in the Middle East and started exporting crude oil to the U.S., the U.S. government imposed import quota in the year 1959. This import restriction by the U.S. government was particularly harsh towards the new comers in the Middle East in view of the fact that these 'minors' lacked refining and marketing facilities outside U.S. Therefore, in order to get more sales the smaller oil companies started offering lower prices. When the oil companies reduced posted prices the producing countries objected to this because it reduced their income by way of tax. The organization of petroleum exporting countries which came into existence in 1960 was primarily meant to protect the income of the producer countries from falling. The OPEC not only has been able to halt the decrease in oil prices once it came into existence but also has been able to increase the price of crude oil especially in recent years. An idea of the extent of the increase in the price of crude oil can be had from the fact that the posted price was increased from $2.59 per barrel in January, 1973 to
$11.65 per barrel in January 1974. The OPEC countries are also pursuing certain other demands like participation with an ultimate objective of complete nationalisation of the oil companies. The acceptance of the demand for participation of the producing countries by the oil companies has led to further problems. Many producing countries do not have their own national oil companies through which they can market their participation crude to outside countries. In the absence of their own companies they are compelled to sell this crude to the international oil companies. Here again the question of price at which this crude is sold to the oil companies arises. Therefore, the relationship between producing countries and the oil companies now depends upon how successfully they have been able to solve all these new problems that have arisen.

After the Arab-Israeli war of 1973 OPEC members have different types of government company agreements. This is

6 Members of OPEC are:

1. Abu Dhabi
2. Algeria
3. Ecuador
4. Indonesia
5. Iran
6. Iraq
7. Kuwait
8. Libya
9. Nigeria
10. Qatar
11. Saudi Arabia
12. Venezuela
13. Gabon

The founder of the OPEC is Jual Pablo Perez Alfonso former Venezuela mines minister.
because of the differences in the abilities of the producer
governments to take the extreme step of nationalisation.
Some of the members of OPEC viz., Abu Dhabi, Kuwait, Nigeria,
Qatar and Saudi Arabia are having participation arrangements
with the companies. Another set of OPEC members, Algeria,
Indonesia, Iran, Iraq and Libya operate industries they
have wholly or partially nationalised. Venezuela has
decided on early nationalisation whereas Ecuador has an
option to participate.\textsuperscript{7} Iran has both a national oil
company as well as partnership arrangement with foreign
companies. With the achievement of 25 per cent participa-
tion in the concessionary companies by 3 countries namely
Saudi Arabia, Abu Dhabi, Qatar on 1st January 1973, there
has been an increasing demand for participation in many
countries in the Middle East. In fact this participation
has been raised to 60 per cent in some countries viz.,
Saudi Arabia, Kuwait, Abu Dhabi, Qatar and Oman and
Bahrain.\textsuperscript{8} This gave the state companies title to oil
produced by the companies to the extent of participation,
but when they do not have the facility to market this oil

\textsuperscript{7} "End of an Era" Fortnightly Journal of Industry

\textsuperscript{8} Ibid.
Internationally they had to sell a part of it back to the companies. The price at which they sold this oil was somewhere between the tax paid cost and posted price. But recently the producing countries have been able to raise the price of this 'buy-back' oil to 93 to 94.8 per cent of the posted price. The producing countries raised posted prices, got participation, raised royalty rates, increased the price of buy-back oil. As a result of all this the companies now have very little incentive left to produce and export oil. It is almost certain now that the oil producing countries gradually want to take over completely the oil companies by way of nationalisation. The fact that it has not happened already is because these countries lack the scientific, technical and managerial abilities to run this highly developed industry. But there is no doubt that these countries are going to acquire them. When this happens the international oil companies will become buyers of crude instead of sellers, because the 'down-stream' operations like refining, transport and marketing in most parts of Europe and U.S.A. are still in the hands of the major international companies.
Effects on International Trade

What effects these developments have on national economies and international trade is very interesting.

As far as international trade is concerned a rise in the price of oil will increase the export earnings of the oil exporting countries and raise the import costs of oil to importing countries. Oil importing countries will have to devote more resources to make up for these higher costs by exporting more goods and services. There will be a redistribution of income from importers of oil to oil producers through a change in terms of trade. However, oil importing countries may try to protect themselves by reducing their consumption of oil. This depends on the availability of substitutes and the development of technology in those countries. Moreover, it is also doubtful whether the improvements in terms of trade in favour of oil producing countries can be maintained for a very long period of time. Because ultimately the price of oil will be limited by the possibility of producing substitutes for oil in advanced oil importing countries. The technological developments in advanced countries may develop substitutes for oil and once this happens the
advantage now enjoyed by oil producing countries will
disappear. While this may take a long time the immediate
problem faced by oil importing countries is the balance of
payments deficit.

The balance of payments deficit of the oil importing
countries becomes the surplus of the oil exporting
countries. The size of this surplus depends on the level
of oil prices, volume of trade, taxing policies and rates
of exploitation. The oil exporting countries may use this
money to buy commodities manufactured in advanced
countries. However, it may not be possible for some
under populated oil exporting countries to spend all
this money on purchase of goods. To the extent they are
not able to spend all this money some surplus will
accumulate. This provides a capital inflow to balance
the current account deficit of the oil importing developed
countries. However, if the surplus funds are held in
liquid form and used to speculate on currency markets it
will cause fluctuation in exchange rates. This is not
in the interest of the producing or consuming countries.

Therefore, the funds accumulated by oil producers
must be spent on goods produced by advanced industrial
countries or be placed on the capital markets of such
countries. Either way the balance of payments problem of those countries disappears. The developed oil importing countries are fortunate in this respect compared to oil importing developing countries which can expect very little by way of capital flows from oil exporting countries to them or exports to the oil producing countries. Therefore, the developed countries can adjust to higher oil import bills with less disruption. But however these funds will have to be invested by them in such a way that they will yield returns at least equal to the rate of interest charged by the lenders. The developing oil importing countries will not be able to attract capital flows from oil exporting countries nor are they in a position to sell more to oil exporting countries. They are not in a position to compete with advanced countries who can offer a variety of consumer and capital goods to the oil exporting countries. Therefore, the developing oil importing countries are the worst sufferers of the increase in oil prices. The effect of the international oil crisis on any particular country depends upon the extent to which that country is dependent on oil imports and the level of development reached by that particular country. However, it is not possible to take the case of each country separately which is beyond
the scope of this study. For convenience of analysis we can group the different countries on the basis of their oil resources and level of development. These categories are:

(1) The oil rich developing countries.
(2) The oil importing industrialised countries.
(3) The oil importing developing countries with inadequate oil resources.

The Oil Rich Developing Countries

The oil rich developing countries in the Middle East and North Africa who are members of the "Organisation of Petroleum Exporting Countries" (OPEC) are the highest beneficiaries of the unprecedented increase in the price of oil in the international market. These countries own non-renewable resources which they export to developed and developing countries. Many of these countries have accumulated large surpluses of oil revenues. Therefore, some of them might cut back production and allow the oil to be accumulated in the ground. For example Saudi Arabia and Gulf Sheikdoms earn more foreign exchange than they can use on development programmes. 9 Libya, Kuwait, Qatar,

and Abu Dhabi are also said to be in this category. This surplus they can invest in advanced categories or lend it to them. In the face of increasing oil prices these countries will be tempted to reduce production and store crude underground. However in case of some oil exporting countries like Algeria, Iran the need for rapid industrialisation and the diversification of the economy which increases the capital goods imports from the developed countries tends to discourage the cut in production.

Since these countries have the scarce and non-renewable oil resources, they try to get the maximum benefit out of it. It is with this intention that the 13 oil producing countries have come together in OPEC. However, the price of oil is limited by the possibility of producing substitutes in advanced countries. A very high price for oil will tend to provoke the substitution. Therefore, the optimal price strategy that the exporting countries should follow is to increase the price of oil just enough to avoid tempting long run adjustments in advanced countries.
The Oil Importing Industrialised Countries

The United States, Japan and Western Europe account for bulk of the world oil imports. The dependence of these countries on imported oil has increased over the last two decades. These countries, however, differ in terms of domestic oil resources. U.S.A. has large amounts of oil reserves but since its total consumption of petroleum products is also very high it depends on imports to the extent of 30 per cent of its consumption. On the other hand Japan is completely dependent on imported oil. Western Europe is also not favourably placed and it depends largely on imports. But North sea oil prospects have increased the hopes of regional self-sufficiency considerably. The following table 8.1 shows the extent of self-sufficiency in oil in case of U.S.A., Japan and Western Europe.

Table 8.1
Extent of Self-sufficiency in Oil, in Oil Importing Industrialised Countries

<table>
<thead>
<tr>
<th>Countries</th>
<th>Oil self-sufficiency 1972</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.A.</td>
<td>69 per cent</td>
</tr>
<tr>
<td>Japan</td>
<td>0 &quot; &quot;</td>
</tr>
<tr>
<td>Western Europe</td>
<td>3 &quot; &quot;</td>
</tr>
</tbody>
</table>

Of the industrialised countries Japan lacks domestic oil resources and it depends on the Middle East to the extent of 90 per cent of its oil imports.

These countries can meet their current account deficit arising from oil imports either by capital flow from the oil exporting countries or by exporting more to those countries. They have also other policy alternatives open to them. They are:

1. Reduce or stabilise imports by exploiting available domestic reserves more intensively, by using technology to develop substitutes.

This strategy supposes that bargaining power of oil importers vis-a-vis oil exporters depends partly upon their possession of technology to produce substitutes for oil.

2. Entering into bilateral arrangements with oil exporters: A number of consuming countries have entered into bilateral agreements with oil producing countries. One such agreement is between France and Saudi Arabia.
The Oil Importing Developing Countries

This group covers a large number of developing countries in Asia, Africa, and Latin America. It is this group of countries which has been hardest hit by the developments in international oil position. The problems faced by these countries, of course, are different depending on their size, population and social systems. Yet generalisations are possible. These countries are aiming at rapid economic development and therefore they face the need to increase their oil supplies. These countries face the problem of foreign exchange since the oil import bill has gone up tremendously. For example, in case of India, the oil import bill has gone up from just about Rs. 200 crores in 1972 to more than Rs. 1300 crores in 1976. Unlike the developed oil importing countries who can meet their current balance of payments deficit by capital flows from oil exporting countries, the developing oil importing countries have to pay for oil imports through their noses. They have nothing to fall back upon to meet their deficits on oil imports except to export more. These countries have also another disadvantage compared to the developed countries who export capital goods to the oil exporting countries and therefore can recover the cost of oil imports by an increase in the price of
the commodities they sell. The developing oil importing countries on the other hand have to import capital goods also and have to pay higher prices for capital goods. The developing oil importing countries are, therefore, doubly hit by the international oil crisis. It has been a double edged sword for them. The only alternative left to them is to develop domestic oil resources in countries where they are available and to encourage use of alternative sources of energy.

Communist Countries

There is another group of countries which has benefitted by the developments in the international oil situation. These are the communist countries. The Russian oil exports to Italy, Finland and West Germany, though form only 2 per cent of world consumption are going to increase the oil revenue to the Soviet Union. China has also benefitted by this development in its oil exports to Japan.