CHAPTER SEVEN: CONCLUSIONS

Theoretical Paradigms

The primary aim of this study has been to attempt to develop a theoretical construct or paradigm, which could satisfactorily explain the flow of international energy transactions during the period 1930 to 1990. The choice of this specific time frame has been predicated on the fact that during this period the international petroleum system evolved through three distinct structural phases:

(a) The first phase covering roughly the period 1930 to 1970 during which the international petroleum order was dominated by an oligopoly of seven or eight vertically integrated multinational oil companies, with their virtual stranglehold on all stages of the production of petroleum and its associated products, with the oil producing countries being relegated to a relatively subsidiary role in the decision making process.

(b) The second phase commencing in October 1973 and lasting upto 1980 during which the international petroleum order was dominated by a cartel of oil producing nations under the banner of OPEC.
(c) The third phase beginning roughly around 1981 and lasting up to the end of the decade which was marked by a decline of OPEC power in terms of its capacity to exercise control over international oil transactions; instead it was the market represented by the forces of demand and supply which increasingly determined the international price and output of oil.

The existence of these three distinct structural phases in the evolution of the international petroleum order is a matter of historical fact which has been well documented in the vast literature on the subject. Some of the interesting research questions that arise are: Was there an organic link between the three phases so that the emergence of each phase was not merely accidental? Is there a paradigm, which can satisfactorily explain the evolution of petroleum transactions over this period? These were some of the major concerns that have prompted the present study.

A survey of the voluminous literature that exists on the developments relating to the oil industry during this period however revealed that despite the immense academic importance of these issues, serious theoretical work on the subject is both meagre and unsatisfactory. In the words of a perceptive analyst, “a void exists at what should be the centre of the field.”
There are essentially three important competing paradigms which could provide us an insight into the theoretical questions that we have raised: (i) neo-classical economics; (ii) the realist paradigm and (iii) regime theory. Of the three, neo-classical economics does provide very useful insights into economic consequences of political action such as the unilateral price increases effected by OPEC during the period 1973-74 and 1979-80. It also provides us with excellent tools for understanding the long-term evolution of the international petroleum sub-system. However the picture that it ultimately provides is essentially uni-dimensional as missing from it are the political and organisational elements which are so crucial to an understanding of the international petroleum order as it evolved from The Red Line Agreement of 1928 to the Gulf war of 1990.

The realist view gives primacy to the role of power, leadership and interest in determining outcomes in international petroleum transactions. While such a world view undoubtedly contains important kernels of truth as applied to the world of international oil, missing from it is the organisational element and the collusive arrangements that various key actors, state as well as non-state, entered into to sustain the petroleum order during the first two
phases. A more serious infirmity relating to the realist paradigm is that it affords little or no importance to non-state actors such as corporate entities, except perhaps as adjuncts to state power. As we have seen, the role of transnational oil companies in sustaining the international petroleum order has been far too crucial to be brushed aside in this fashion. Finally the realist conception accords too little importance to the underlying economic conditions on which the petroleum order was based during the different phases of its evolution, which for an internationally traded commodity such as oil would be misleading.

We have argued in this study that regime theory provides perhaps the most satisfactory tools for analysing the structural evolution of the petroleum order during the three phases mentioned earlier. Focusing as it does on organisational and collusive arrangements involving key actors while at the same time not precluding the influence of power and interest in determining policy outcomes, it is particularly suited for applicability to the international petroleum system where collusive oligopolistic or cartel type arrangements between key actors have been pervasive.
In applying regime analysis to the international petroleum system, we began with Krasner’s consensual definition of regimes, namely that regimes are “sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors’ expectations converge in a given area of international relations.” We felt that this definition was elastic enough to encompass a wide spectrum of regimes - from formalised contractual arrangements involving nation states to the informal, non-contractual arrangements among non-state actors. It is in this very definitional flexibility, permitting its applicability to wide range of situations in international relations, lay the real strength and utility of Krasner’s formulation.

For the purpose of applying these concepts to the international petroleum system, we drew upon two strands of thought within regime theory - the Grotians who regard the existence of regimes as pervasive aspects of international relations and the modified structuralists who regard the existence of regimes as special cases in circumstances when unfettered individual action is likely to result in non-Pareto optimal outcomes necessitating collusive arrangements. Against this conceptual backdrop we postulated that: (a) a regime may be contractual, semi- contractual or non-
contractual; (b) a regime may involve state actors as well as non-state actors; (c) a regime may be institutionalised or non-institutionalised and; (d) a regime at different times could function as an intervening or an independent variable.

The First Oil Regime

Based on these concepts we have tried to establish that beginning around the year 1928, an informal, semi-contractual regime was established in the international petroleum system. The regime involved both state as well as non-state actors, namely the oil exporting states and a group of seven large vertically integrated multinational oil companies, often referred to as the ‘seven sisters’. The operation of the regime encompassed all the stages in the manufacture of petroleum and petroleum products, namely production of oil, its refining, transportation and distribution. Until the early 1960s, the regime regulated over ninety percent of the world’s trade in petroleum.

The First Oil Regime was based on three dominant norms and principles:

(a) The production of petroleum was to be on the basis of long-term concession agreements between the oil companies and the producer states. The concession agreement, which was essentially a contractual relationship between the government of the oil producing country and
the multinational Oil Company, or a consortium thereof, specified the award of the right to exploration, development and the production of oil to the oil companies. It also specified the distribution of rents arising from the production of oil (in the form of royalty payments and profit sharing) between the oil producing country and the concessionaire. An explicit principle embodied in these contracts was that the effective management and control of the exploration, development and production of oil would remain with the concessionaire company, with the host country being entitled to only the payments of royalties and sharing of profits as stipulated in the agreement. The concession agreements thus formally laid down the norms, principles and procedures governing the production of oil as also the broad parameters of the relationship between the oil companies and the oil producing countries. The early concession agreements did undergo some modifications in the 1950s, particularly regarding the manner of profit sharing and the calculation of oil prices. The basic structure, however, remained unaltered till the early 1970s, indicating thereby that this norm had relatively wide acceptance.
An oligopolistic arrangement among the major international oil companies was necessary for providing stability and predictability in the international oil market. This oligopolistic control was formalised through an elaborate set of agreements and procedures aimed at eliminating inter-corporate competition and minimising internecine conflict. Of these, The Red Line Agreement was aimed at limiting competition at the production stage by eliminating potentially destructive corporate conflict over obtaining oil concessions in the areas of the erstwhile Ottoman empire. The Achnacarry or ‘As Is’ Agreement provided the basis for dividing up world market shares among the major international oil companies. The Instructional Agreements laid down detailed procedures for operationalising the ‘As Is’ arrangement at the regional level and included procedures for dispute resolution. The long-term supply contracts were aimed at limiting the disturbance to the oligopolistic arrangements due to fresh oil supplies from new discoveries. Through these wide ranging agreements, backed up and enforced through detailed procedures, dispute resolution and coordination mechanisms, the seven major international oil companies came to acquire a vice-like control over
the international petroleum system. By 1946 these companies had come to control an astonishing 90 percent of the world's oil production outside the US and USSR.

(c) An integrated form of industrial organisation, encompassing the three main functions, namely production, processing and marketing, was best suited to meet the requirements of stability and efficiency in the international oil system. In an oligopolistic international oil industry, vertical integration was necessary for the purpose of exercising proper management control and co-ordination over the different stages of petroleum production as well as for maximising retained profits. In order to sustain the international petroleum order created by the oil majors, the oil companies consciously pursued a strategy envisaging vertical integration of business functions. The fact that till around 1970, vertical integration was a well-established norm of industrial organisation can be gauged from the fact that all the major international oil companies were vertically integrated.

While these were the dominant norms, there were certain sub-norms, which could be regarded as derivatives of the main set. These nevertheless require specific mention in order to highlight the contrast with the norms on
which the subsequent oil regime was based. The important sub-norms that were implicit in the First Oil Regime were:

(i) Competition in the international oil system was neither necessary nor desirable for the efficient functioning of the international oil system. This of course flowed from the dominant norm that oligopolistic arrangements were necessary to provide order, stability and predictability to the system and that unbridled competition was likely to inject dangerous instability and volatility into the system which was neither in the interests of the consumers nor of the producers.

(ii) Direct state intervention in the international petroleum system was to be eschewed, as private enterprise was best suited to serve the interests of both consumers and producers. This sub-norm was a logical corollary of the accepted position that the oil majors possessed the requisite attributes in terms of the technical expertise, the managerial capability and the venture capital to run the international petroleum system efficiently and equitably. Government intervention in the system was therefore neither necessary nor desirable.
On the important issue of the relationship between regime and state power, we found that the First Oil Regime was established in the context of hegemonistic British colonial power and in the initial stages, commercial objectives were made subservient to British strategic interests. This conforms closely to the classical realist conception of the relationship between regime and state power. However, with the decline of British colonial power and the rise of the hegemony of the United States, this relationship underwent a significant change. The US allowed substantial regime autonomy and commercial interests often took precedence over strategic ones. This is closer to the Grotian conception of regimes in which regimes once created often take on an existence of their own which is independent of state power and not necessarily dependent on it.

The Path to Regime Change

The First Oil Regime survived largely intact till the ‘oil shocks’ of the early seventies. However its raison d’être had begun to be questioned much earlier. One major issue related to the distribution of rents arising out of the concession arrangements, which were perceived by the oil producing states to be heavily skewed in favour of the multinational oil companies. This issue was resolved, albeit only for some time, with the evolution of the so-called
‘fifty-fifty’ principle which envisaged an equal division of net profits between the oil producing states and the companies. This became the accepted principle for the division of rents in relation to the concession agreements and was a prudent move on the part of the companies for satisfying host country demands without changing regime parameters.

The abortive nationalisation attempt in Iran in the early 1950s constituted a much more serious threat to the existing oil regime. Although the Mossadeq regime acting in isolation simply did not have the wherewithal to challenge the combined might of the ‘seven sisters’, backed up as they were with the state power of the United Kingdom and, more importantly of the United States, the episode did constitute an important turning point for the First Oil Regime. It established the important principle that oil assets in principle belonged to the host country, namely Iran, and the concept of a concession agreement in the operation of which the host country had little or no say was replaced by a process of negotiation and mutual agreement, albeit with the multinational oil companies retaining effective control.

The establishment of the revolutionary government in Iraq in 1958 was another important milestone in the process towards regime change. After negotiations broke down with the Iraq Petroleum Company (IPC), a
consortium dominated by the oil majors, on fundamental issues such as relinquishment of large undeveloped areas covered by the concession, equity participation by the government in the IPC and profit sharing arrangements between the government and the consortium, the Iraqi government, in October 1961, unilaterally expropriated around 99 percent of the concession area of the IPC group through the promulgation of a law. It also passed another law reserving all the unexploited areas in Iraq for the newly set up, state-owned Iraq National Oil Company. It, however, stopped short of nationalization, cognizant of the fact that acting in isolation, it would not have been able to sustain such a course of action, which struck at the very heart of the prevalent oil regime. These developments, however, did establish an important principle in the evolution of concession agreements under the first regime, in that provision for the automatic relinquishment of concession areas became a standard principle in new concession agreements and also came to be incorporated in modification of the existing agreements.

By the close of the decade of the 1950s, the process of change that had manifested itself on the fringes of the existing oil regime was accelerated on account of several mutually reinforcing factors:
(a) The increased competition for new concessions to explore for and produce crude oil and the entry of new non-integrated oil firms, usually referred to as 'independents', had a major impact on the pattern of concession terms, particularly on the distribution of benefits, which undoubtedly were considerably more favourable to the host countries than in the earlier concessions that had been signed almost exclusively with the oil majors. Thus the resulting competitive bidding for concessions had the effect of substantially raising the rents accruing to the host governments. This altered the distribution of benefits within the existing oil regime without significantly disturbing the regime framework.

(b) The entry of independents was to a large extent responsible for the expansion of world supply - the share of independents in world crude oil production rose from around 4 percent in 1952 to nearly 18 percent in 1965. This loosened the control of the oil majors on crude oil prices as well as their hold on the downstream market. The newcomers being unintegrated did not have the refining facilities or the marketing networks to handle the increased output. This expectedly led to the growth of refiners independent of the oil majors - between 1950 and
1966, the percentage of world refinery throughput handled by the seven international oil majors fell from 72 to 61. In effect the competition for new sources of crude oil, for refining capacity to process the additional crude and for product markets spawned new patterns of organisation of the production, processing, and the distribution of petroleum products. In the process, one of the important norms of the first oil regime, namely vertical integration was being seriously eroded.

(c) In the late 1950s and throughout the 1960s government policies became of increasing significance to the international petroleum order, diminishing in the process the virtually unfettered control exercised by the oil majors in the past. Such intervention mainly took two forms: one was the entry of national (though not necessarily state-owned) oil companies of some of the important importing countries (primarily French, Japanese and Italian) which in their quest for providing oil security for the countries of their origin, entered into innovative arrangements with the oil producing countries which were very far removed from the pattern of the early concession agreements secured by the oil majors. In fact, ENI, the Italian state oil company,
took the lead by openly advocating a preference for government to
government contracts in lieu of the arrangements made with the
international oil companies. The second important aspect of state
intervention was a consequence of the growing assertion of rights by
the producing countries for a greater degree of participation in the
conduct of the oil industry located within their national territories.
This resulted in the setting up of state-owned National Oil Companies
in almost all the major oil producing countries by the late 1960s. Very
clearly a state controlled oil sector outside the ambit of the existing oil
regime was slowly emerging.

(d) Any discussion of the factors responsible for regime transformation
would be incomplete without a mention of the formation of the
Organization of Petroleum Exporting Countries (OPEC) which was
established in September 1960 initially by five major petroleum
exporting countries, namely Iran, Iraq, Kuwait, Venezuela and Saudi
Arabia. Although the proximate cause of the formation of OPEC was
a sense of outrage at the unilateral reduction in oil prices by the oil
majors, it was in fact a culmination of the simmering sense of
discontent among the oil producers with the existing oil regime which
was perceived to be heavily skewed in favour of the oil majors and the oil importing nations. The aims of the organization, as articulated in the first two Resolutions, *clearly envisaged the creation of an alternative petroleum order in which the oil producers would exercise effective control over both production and prices*. However, the weakness of the oil market throughout the decade of the 1960s on account of the plentiful supplies of crude oil combined with the intrinsic strength of the existing oil regime, prevented the oil producing countries from developing any concrete consensual plans of action that could effectively threaten the existence of the old order. The creation of OPEC was indeed a significant development, not in terms of its immediate impact on the existing oil regime, but in the coming into existence of potential countervailing power with clearly articulated norms and objectives that conflicted with those of the prevalent regime. The creation of an organisation with well defined organs and clearly laid down procedures, whose members in 1968, together accounted for 69 percent of the world’s total petroleum reserves, had laid the foundation for the creation of an alternative petroleum order, if the existing regime were to collapse.
Some comment is necessary here on the process of regime transformation as witnessed in the international oil system since the late 1950s through the decade of the 1960s. As we have seen, according to the structural realists regimes have essentially no independent existence of their own and are merely projections of the underlying power structure. Hence, according to this view, both regime creation and regime change are contingent on changes in power relationships and interests. In other words, since interactions within the regime are of little consequence, change occurs on account of factors that are exogenous to the system.

As we have argued earlier, the realist conception does not hold up too well in its application to the international petroleum system. The main factors driving the process of regime change during the first oil regime were: (i) demand of the oil producing countries for a greater share of the rents; (ii) demand of these countries for greater control of oil operations within their territories; (iii) increased competition in the oil system and entry of new players; (iv) increasing state intervention in the oil industry and; (v) growing solidarity among the oil producing states resulting in the formation of OPEC and the articulation of norms which could form the basis of an alternative international petroleum order. All, or at least many, of these processes were
consequences of the operation of the regime itself and were not external to the system. The main drivers of regime change were thus endogenous to the regime, which squares up well with the Grotian conception, which considers regimes as pervasive phenomena of the international system and not mere adjuncts of power relationships and configuration of interests. It is thus clear that the first oil regime came to function as an independent variable with tangible consequences on the international petroleum system that were, in most part, not directly linked to changes in the underlying structure of power relationships.

**Regime Collapse**

By the close of the decade of the 1960s, the first oil regime had been greatly weakened on account of the factors outlined above. In the space of a few years, it was to collapse due to certain significant economic and political developments, which are summarised below:

(a) Beginning in the late 1960s and continuing through the early 1970s, the international oil market underwent a significant transformation from a buyer’s to seller’s market. This was partly due to the rapidly growing world consumption of energy coupled with the increasing substitution of coal by oil - between 1950 and 1970, the share of coal
in world energy consumption declined from 55.7 percent to 31.2 percent, while at the same time the share of oil went up from 28.9 percent to 44.5 percent. This translated into a sharp rise in the demand for oil. More importantly, due to a sharp decline in world spare capacity in crude oil production, the supply of oil in the international market became inelastic. This was linked primarily to the decline in spare capacity in the United States, which, after a period of self-sufficiency till the early 1960s, was importing almost one-third of its requirements by the early 1970s. This implied a rising dependency of the industrialised consuming countries on Middle Eastern oil.

(b) The closure of the Suez canal in the aftermath of the 1967 Arab-Israeli war had far reaching consequences for the international oil trade - it placed the Persian Gulf oil producers at a locational disadvantage vis-à-vis the Mediterranean states, particularly Libya and Algeria, in terms of proximity to Western Europe, the main destination of Middle Eastern oil. The revolutionary government which seized power in Libya in 1969 soon took advantage of this situation and under threat of nationalisation of the concessions of the independents (who were particularly vulnerable because of their almost total dependence on
Libyan oil) concluded a far reaching agreement with the oil companies, known as the Tripoli I agreement, which had the effect of raising both posted prices as well as the rate of taxes on oil production. The developments in Libya had significantly altered the oil company-country relationship by clearly demonstrating that the major oil companies were no longer invulnerable and could not anymore function as a power centre independent of the governments of the countries in which they operated.

(c) The success of the Tripoli I opened up a virtual Pandora’s box and laid the ground for further company-country agreements. The process now was also institutionalised with the full involvement of OPEC, which in the case of Tripoli I had rendered only moral support. Thus the Tehran Agreement and the Tripoli II Agreement were concluded in February and March 1971 respectively which raised the posted prices of crude in addition to providing freight and quality premiums. With the conclusion of these agreements, the pendulum of oil power had swung decisively in favour of the oil producing states and OPEC was finally recognised by the multinational oil companies as a legitimate representative of the oil producing countries. These three
agreements were followed up by another two, namely the Geneva I and Geneva II agreements which, apart from raising posted prices, also contained provisions aimed at safeguarding the earnings of the oil exporters against international inflation and exchange rate fluctuations. The real significance of these agreements lay in the fact that the determination of posted prices, a function which was earlier being performed almost exclusively by the international oil companies, was now being done by the oil producers, albeit through a process of negotiation with the oil companies. The old regime was clearly in a terminal state of decay.

(d) While wrestling the initiative in price determination, the oil producing states were also seeking working interests in the oil concessions which would have enabled them to operate the concessions as partners. This was expectedly resisted by the oil companies as it implied a qualitative change in the historical relationship between the oil producing states and the oil industry and struck at the very core of the existing regime. However in the early 1970s the dice was loaded against the oil companies. The nationalisation of British Petroleum by Libya in December 1971 and the nationalisation of the Iraq Petroleum
Company in June 1972 broke the back of the oil companies’ resistance. In the aftermath of the Arab-Israeli war of October 1973 a new order emerged in which some of the concessions were nationalised, some had 100 percent participation agreements and in others the producing countries had majority participation levels. The producing countries had thus acquired effective managerial control of the concessions within their national territories and one of the main pillars of the old regime had irrevocably crumbled.

The Second Oil Regime

The first oil regime was in its death throes and it only required a push to finally bring it crashing down. This ultimate blow came in the form of the Arab-Israeli war of October 1973. Taking advantage of the disruption in supply caused by the hostilities, on October 16 1973, the Persian Gulf members of OPEC announced a unilateral increase in the posted prices, which raised the price of Arabian Light, the key crude in the Gulf region, by an unprecedented 170 percent. This announcement marked the beginning of a new petroleum order as it established OPEC as the sole arbiter of oil prices, finally breaking the long established tradition of consultation and
negotiation between the producer states and the oil companies prior to any upward revision in crude oil prices.

The unilateral increase in prices of crude oil by OPEC set the ball rolling for further such revisions. In December 1973, the Gulf members of OPEC again raised the posted prices of the Arabian Light marker crude by 227 percent effective from January 1, 1974, making the cumulative increase from October 1973, of over 384 percent.

The impunity, with which such massive increases had been effected, indicated quite clearly that OPEC had established itself as a cartel of autonomous petroleum producers. This coupled with the increasing levels of participation in the concessions by the governments of the oil producing countries as also the growing involvement of the national oil companies, had reduced the once powerful international oil companies to the role of technician-managers with regard to upstream operations, although in the downstream business their control remained relatively unaffected. This organisational inter-relationship marked a significant departure from the past and was one of the main characteristics of the new regime that had come into existence.
The massive increases in the prices of oil had their expected economic consequences. There was a major decline in the level of economic activity in the industrialised world - real GNP growth in the OECD countries which had averaged over 5 percent per annum during 1959 to 1972, plummeted close to zero in 1974-1975. With this followed the decline in the demand for oil, effectively thwarting any attempts by OPEC to raise prices further. In fact the excess supply situation following in the wake of these developments exacerbated intra-OPEC tensions, forcing members to adopt voluntary production cutbacks despite their need to raise revenues from oil.

The oil shock of 1973-1974 caught the industrialised consuming countries quite unprepared. Their initial response was to develop elaborate energy policies and this marked the beginning of the growing activism of governments in energy affairs. The United States took the initiative towards evolving a comprehensive co-operative energy programme among the Western industrialised countries to meet the energy crisis. This was to result in a ten year blueprint for a new ‘international energy programme’ (IEP) which also envisaged the setting up of an International Energy Agency (IEA) as a separate entity to administer this programme within the OECD. The IEP contained short-term programs as well as long range policies. The
former included discouraging members from bidding competitively against each other for available oil supplies, establishing stockpiling requirements, mandatory demand constraints in the event of supply shortfalls, etc. The objective of long-range policies was to reduce dependency on imported oil, to develop an oil market information system and framework for consultations with the oil companies, and above all to elaborate a common strategy for a dialogue with the oil producing states.

With the setting up of the IEA in November 1974, the IEP was formally institutionalised and a firm foundation laid for the process of energy co-operation among the oil consuming nations of the OECD. The international petroleum system was now divided into two polar blocs: the oil producers represented by OPEC and the major consumers under the banner of the IEA. Though overt and formal co-operation between the two groups was scarcely feasible, the underlying linkages were provided by:

(a) the activities of the multinational companies who handled most of the world wide downstream operations - in 1976 the international oil companies still marketed 75 percent of all internationally traded oil;
(b) the integral linkages of international trade with the almost complete dependence of most of the oil producers on imports of goods and technology from the industrialised oil consuming nations; and

(c) the ‘special relationship’ between Saudi Arabia, the leader of the oil producers and the United States, the leader of the industrialised consuming nations, which provided the necessary restraint and moderation for the stability of the second oil regime.

The above factors combined with the flexibility of approach adopted by OPEC, in concerning itself primarily with the issues of price fixation, while leaving the thorny and contentious issues of production and export levels to member countries and market shares to oil companies, that ensured the stability of the cartel and, in turn of the oil regime during this period.

Some mention must be made here of the stance of the United States towards the second oil regime. The post World War II world order was characterised by the hegemony of the US and the stability of the first oil regime rested to a large extent on this foundation, although after the Iranian episode in 1954, the US adopted a laissez faire oriented policy towards the regime.
The coming into existence of the second oil regime confronted the US with a major policy dilemma as it was caught between multiple, mostly conflicting, policy objectives, leading to, what some analysts have termed, a ‘faltering and incoherent’ response. Some of the main factors conditioning the US response to the second regime were:

(a) The ‘oil crisis’ affected the industrialised world differentially as their patterns of oil import dependence were radically dissimilar. The US was much less affected than W.Europe or Japan. Further, on account of pressure from the domestic oil industry, the US had imposed import quotas to restrict the inflow of cheap Middle Eastern oil, resulting in artificially high oil prices in the American market. This was a major competitive disadvantage for the US industry vis-a-vis its counterparts in W.Europe or Japan. For certain powerful domestic pressure groups in the US that exercised considerable influence over foreign policy outcomes, the leveling of the competitive field in the wake of the oil price rise was not entirely unwelcome.

(b) As the leader of the industrialised consuming nations, the US had to maintain consumer solidarity and prevent bilateral deals with OPEC by major consuming nations which would have seriously eroded the
bargaining power of the group as a whole. This was the primary motive behind the establishment of the IEA.

(c) This, however, did not prevent the US from pursuing its own bilateral relationship with Saudi Arabia with the objectives of: (i) driving a wedge within OPEC; (ii) enhancing the oil security of the US and (iii) to weave Saudi Arabia into a relationship of long-term interdependence with the US

(d) The US commitment to support Iran (specifically the Shah’s regime), a price hawk in the OPEC, as a part of its policy of containment of the Soviet Union.

(e) The ultimate ‘American Dilemma’ was the need to support Israel due to powerful domestic compulsions while at the same time preserving the strategic security interests of the US which dictated a friendly and sensitive engagement of the Arab world.

The first oil regime, which was in its last throes finally collapsed with the October war of 1973. This was the turning point in the establishment of a new petroleum order which, we have argued, could be termed as the second oil regime. In the absence of any treaty or formal agreement, the regime was informal and non-contractual. It comprised both state as well as non-state
actors, with the latter playing a far more significant role than in the first regime. In addition, with the existence of OPEC and the creation of the IEA, there was much greater institutionalization in the second regime in comparison with the first.

The second oil regime was based on the following norms and principles:

(1) The producer countries should have effective control over their own resources;

(2) Cartelisation of oil production through a cartel of oil producing nations was the appropriate instrument for providing both equity and stability in international petroleum transactions;

(3) Petroleum was strategically much too important a commodity for production, pricing and consumption decisions to be left to the market mechanism - state intervention in the oil market was thus both desirable and necessary; and,

(4) With the production of oil being controlled by the producer states, the function of processing, transportation and distribution of petroleum and petroleum products should be performed by the international oil companies.
The second oil regime was relatively short-lived on account of several reasons. Firstly, the norm of cartelisation of oil production, particularly the aggressive stance on the price front, was widely challenged and ultimately proved unsustainable. Secondly, although the first oil regime steadfastly discouraged competition, it essentially functioned within the framework of the market system which enabled a level of fine-tuning which was altogether absent in the second regime. The second oil regime attempted to determine prices administratively than through the market mechanism. Finally, the first oil regime was founded on an excellent information system made possible by the vast international network of the multinational companies, which enabled a fine calibration of demand with supply resulting in a remarkable stability of prices. By altogether delinking the oil companies from pricing and production decisions the regime shut its door to information which was vital to its own survival.

There were four major consequences of the operation of the second oil regime that had a critical impact on its stability and ultimately led to its disintegration:
(a) **Impact on the demand for oil:** During the first oil regime the real price of oil had remained virtually constant and as a consequence, the consumption of oil had grown at a compound annual rate of 7.5 percent in the period 1960-1973. However, due to the aggressive price stance adopted by OPEC as well as the general perceptions of greater future uncertainty concerning oil supplies, led to a decline in oil consumption at an annual rate of nearly 1 percent during the period 1973-1982. This in turn resulted in a significant fall in the share of oil in total world energy consumption from 45 percent in 1979 to 39.3 percent in 1984. OPEC was left with no choice but to cut back on production - between 1979 and 1983, output was down by 44 percent and capacity utilisation fell from 88.3 percent to around 50 percent. As non-OPEC production was expanding rapidly, it was the OPEC countries, which bore the brunt of the demand contraction in order to protect the price structure of crude oil they had created.

(b) **Development of the spot market:** Under the first oil regime, most of the transnational petroleum transactions were internal to the vast international network of the major integrated oil companies and therefore shortages or surpluses in the open market were very
infrequent. Under the second oil regime, the nationalisation of concessions as also the multiplication of operators, contributed to the development of an open market in which arm’s length sales took place between unrelated companies. With the shrinkage of demand and the build up of excess capacity over the period 1981 to 1985, price-cutting was fairly widespread among the oil exporting countries, both OPEC and non-OPEC. As a consequence the international spot market\(^1\) which was negligible during the 1960s, rose gradually to reach the equivalent of an estimated 70 percent of internationally transacted oil in 1985. In fact from the end of 1981, it became increasingly self-evident that it was the spot market that set the international prices of crude oil rather than the OPEC cartel. One of the major edifices of the second oil regime had crumbled to the logic of the market.

(c) **Increased Competition:** In the early eighties, the number of players had increased exponentially resulting in a high degree of competition. This was one of the major consequences of the divestment of the transnational companies of their producing concessions and some of

---

\(^1\) The open market comprises two sub-markets: (a) the term of contract market, which covers sales over a future period which could be as long as three years, and (b) the spot market which gives price estimates on a daily basis.
their downstream facilities resulting in a mushrooming of non-integrated and independent actors in the oil industry. Each petroleum exporting country was now transacting with a large number of customers, including previous concessionaires. With the channels established by the multinational oil corporations in disarray due to the large number of players and increased competition, oil buyers had come to rely increasingly on the spot market to correct imbalances between demand and supply. With these developments, the power and the manoeuvrability of OPEC had greatly diminished. Instead, it was the market that determined the structure of international oil transactions.

(d) Growth of Non-OPEC Production: The large price hikes initiated by OPEC between 1973 and 1980 elicited another predictable market response - they served to stimulate production in other parts of the world. As a consequence, the share of OPEC in world oil production came down dramatically from a level of 53.5 percent in 1973 to a mere 29 percent in 1985. The major non-OPEC oil exporting countries that had a significant impact on the world oil market were Mexico, the United Kingdom, Norway and the Soviet Union. These
countries, by and large, followed independent pricing and production policies that were consistent with their own national interests and it was ultimately the OPEC that had to bear the brunt of the impact of the expansion of non-OPEC oil production. Between 1973 and 1985, while world oil production declined marginally from 58.5m b/d to 56.9m b/d, OPEC production almost halved from a level of 31.3m b/d to 16.5m b/d over this period. By producing at full capacity and selling at competitive prices below the officially announced prices of OPEC, the North Sea producers, UK and Norway had effectively whittled away the last vestiges of OPEC power to dominate the oil market.

OPEC was clearly on the horns of a great dilemma. The logic of the market had posed to it a Hobbesian choice: It had to cut prices if it wanted to regain market share or cut production in order to maintain control over prices. Though both courses seemed equally unpalatable, it opted for the latter as cutting prices would tantamount to dismantling the very foundation of the oil regime that they had created and the loss of power and influence, not to mention the surrender of political and economic gains, that this implied. Beginning March 1982 and up till late 1984, OPEC attempted to
enforce production quotas for its members. It thus tried to transform itself into a classical cartel, fixing production levels as well as price.

In the soft market conditions that prevailed at the time this course of action was simply unrealistic. There was widespread cheating by member countries and this coupled with the aggressive production policies adopted by the North Sea producers, implied that OPEC was no longer in control of the international oil market. Coming finally to terms with the realities of the situation, OPEC in late 1985 formally abandoned policies designed to protect the price of oil. Through an official communiqué in December 1985, OPEC formally redefined its role, which henceforth was no longer to protect price, but instead to secure and defend a fair market share for its members. The final surrender to the logic of the market had thus been officially acknowledged.

The transition to a completely market determined system was scarcely smooth. With the absence of a formal price determination mechanism, for the first time in the history of the oil industry, the markets were plunged into chaos. The price of oil in the spot market collapsed within the space of a few months, to one third the level of end 1985. It was evident that the international petroleum system that had over the years evolved under
regimes that involved regulation and price setting was caught unawares by
the introduction of a completely market based competitive environment.

Even among the industrialised oil consuming countries, which could be
expected to welcome falling oil prices, there were apprehensions among
some, such as the US, about the consequences for the domestic oil industry
and, among others, such as Japan, on the long-term impact of unduly low
prices on alternative energy programmes. The oil companies were of course
concerned about the impact of low oil prices on their exploration budgets
and on the economics of oil production from relatively high cost fields.

The most adversely affected were, of course, the oil exporters and this
was not confined only to OPEC. However, attempts to evolve a consensual
approach between OPEC and non-OPEC producers did not succeed. By the
middle of 1986, the OPEC think tanks had worked out a detailed rationale
for a policy that aimed at maintaining the price of crude oil in the range of
US$ 17-19/b. In December 1986, OPEC agreed on a ‘reference price’ of
US$ 18/b based on a composite price of a basket of several crude oils and
also agreed on a quota of 17.3m b/d which they hoped would maintain this
price.
Although most observers of the day were sceptical about the longevity of this arrangement, it survived, albeit with some modifications till the close of the decade. The oil prices during this period ranged between US$ 15-18/b. OPEC members were now more acutely aware that there was no real alternative to this arrangement and that the consequences of persistent quota indiscipline could be disastrous for the group as a whole. Economics had at last triumphed over politics and the world seemed poised to enter an era of primarily market driven energy transactions.

From the viewpoint of regime theory, it is evident that the demise of the second oil regime was on account of factors that were endogenous to the petroleum system and not due to any external imperatives. These factors, such as reduced demand for oil, growth of non-OPEC production, development of the spot market and increased competition, arose as a consequence of the operation of the second oil regime and its concomitant impact on the international oil system. This would lead us to infer that, as in the case of the first oil regime, the second oil regime also functioned as an independent variable with very tangible consequences on the international petroleum order, and not merely as an intervening variable as postulated by the realist conception. While the systemic responses to the first oil regime
were largely political in nature, giving birth as a result to the second oil regime, the latter collapsed as a result of its economic impact on the oil system. Thus whilst it is true that regimes are 'nested' in a political order, for commodity regimes such as oil, the economic context seems to be equally important. In other words, such regimes can change with changes in the economic context, even in the absence of any significant alterations in the underlying political structure. This is tantamount to standing the realist conception on its head but is nevertheless an important finding of the present study. Finally, from the preceding discussion we can assert that the three distinct phases of the international oil system that have been examined here, namely the first oil regime, the second oil regime and lastly the period of market dominance, were each organically linked to each other, with each succeeding phase capable of being logically explained as a consequence of the operation of the preceding one.

Let us now set out the main conclusions emerging from this study. We have established that:

(a) An informal, semi-contractual regime established by seven vertically integrated multinational oil companies existed in the international oil system during the period roughly between 1930 and 1970. The regime
was established under the aegis of Anglo-American power, but subsequently came to function as an independent variable, with the hegemon, the United States, playing a relatively passive role.

(b) The operation of the first oil regime had direct and tangible consequences for the international petroleum system leading to its collapse and the creation of an alternative oil regime. The second oil regime, which came into existence in October 1973 and lasted till around 1981 was informal and non-contractual and dominated by OPEC.

(c) The operation of the second oil regime had major economic consequences for the international oil system leading to its ultimate demise. From 1982 onwards the main drivers of the international oil system were the market forces, with OPEC relegated to the role of a major oil producer only, with little actual control over the oil system.

(d) The main drivers of regime change were endogenous to the petroleum system in that they arose as a consequence of the operation of the regime itself. For the first oil regime, the drivers of change were both political and economic, with the former being of greater significance.
In the case of the second regime, the imperatives towards change arose primarily out of economic factors.

(e) The three distinct phases of the evolution of the international petroleum system during the period under study were organically linked to each other in that the transformation of the system into each succeeding phase could be logically explained in terms of the impact on the petroleum system of the operation of the regime in the preceding phase.

(f) Finally regime theory provides the most satisfactory paradigm for analysing the evolution of international petroleum transactions over the period under study. This is mainly because regime theory, particularly in its Grotian conception, is inclusivist in that within the broad theoretical framework it can allow for the influence of both political and economic factors. Other competing theoretical paradigms, such as neo-classical economics and structural realism are essentially uni-dimensional and exclusivist in that they tend to emphasise only one aspect of a complex structure, be it political power or economic forces, excluding or minimizing the importance of other factors. For this reason, the tools and concepts that they provide
are not wholly adequate for analyzing the evolution of the international petroleum system during the period under study.