CHAPTER TWO: THE FIRST OIL REGIME

Introduction: The Formation of the ‘Seven Sisters’

The petroleum age began with the discovery of oil in Pennsylvania in the mid-nineteenth century. Until the close of the century, oil was used primarily as kerosene for lighting and heating and sometimes as a lubricant. Around the turn of the century, fuel oil for boilers in ships and industry became increasingly important as the significance of kerosene faded with the invention of the electric bulb.¹ The automobile era in the United States commencing around 1911 coupled with the first World War triggered an oil boom with the result that by 1929 petroleum had come to account for one-third of US energy consumption. This proportion had further increased to around 45 percent in 1939 on the eve of the Second World War.²

In the early years of the industry the behaviour of producers and refiners, often single entrepreneurs in the United States, led to sharp swings in supplies and prices, as on the one hand, price cuts were resorted to in the wake of the discovery of prolific oil reserves and, on the other, shortages occurred as exploitation and development slackened or demand surged.

¹ For an excellent introductory account, see Yergin (1991) op cit, ch 1
Through a strategy of cost cutting rationalization, railway and pipeline rebates, predatory pricing, acquisitions and expansion, J.D Rockefeller achieved virtually full control of refinery and later oil transport facilities in the United States by the end of the nineteenth century under the aegis of the Standard Oil Trust. For many years Standard Oil concentrated on building a monopoly in refining, transporting and marketing of oil, leaving the risky business of exploration and production to smaller entrepreneurs. At the same time it retained a virtual monopoly in the world markets.\(^3\)

This monopoly however was set to be undermined by two significant developments. Major oil discoveries in the United States, especially in the state of Texas resulted in the creation of new competitors such as the Gulf Oil Corporation and Texas Corporation (Texaco). Outside the United States the Standard Oil monopoly was challenged by oil discoveries in Russia and the Dutch East Indies. The Nobels and the Rothschilds developed Russian oil into a formidable competitor of Standard Oil in Europe by the late nineteenth century. With the discovery of oil in the Dutch East Indies, the Royal Dutch Petroleum was formed and started competing with Standard Oil.

\(^3\) See Yergin (1991), op cit, ch 2.
in the markets of China and the Far East. World competition intensified further when in 1907 Royal Dutch merged with Shell Transport and Trading of London, which used to market Russian and American oil supplies mainly to the British Navy, to form the Royal Dutch Shell group.

In 1911 the Standard Oil Company was broken up by the anti-trust action of the United States government, and the company was divided up into a number of major oil companies. It is significant to note that prior to its break-up Standard Oil controlled 84 percent of the domestic refinery output, 85 percent of the domestic sales and 86 percent of the oil exports from the United States. This needs to be viewed against the background that by 1914, United States oil production accounted for around 63 percent of the world total. Among the most important companies to be carved out of the original Standard Oil were Standard Oil of New Jersey (subsequently named Exxon); Standard Oil of New York (subsequently named Mobil); Standard Oil of Ohio; and Standard Oil of Indiana. These three Standards along with Gulf Oil, Texaco, Royal Dutch Shell, and British Petroleum (which was formed as Anglo-Persian in the early 1900s to operate a British concession

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4 ibid, ch 3.  
5 ibid, ch 6.  
in Iran), comprised the seven companies that came to be known as the ‘Seven Sisters’. For a period of around three decades commencing 1928, these seven companies, five American, one British and one British-Dutch created an international petroleum order the salient features of which we shall attempt to detail in the course of this chapter.⁸

**The International Oil Concessions**

An integral norm of the oil regime set up by the international oil majors was the nature and structure of the contractual arrangements entered into by these oil companies with the host governments for the purposes of exploration and production of oil in the territories of these countries. These came to be referred to in the parlance of the day as concessions.

To provide a historical background, the first major oil discovery in the Middle East was made in southern Persia in 1908, following the conclusion of a concession signed between the Persian government and a British investor by the name of William Knox D’Arcy in 1901. This was followed by a large number of oil discoveries in Iraq (1927), Bahrain (1932), Saudi

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⁸ For an excellent historical account of the formation of these Companies, their policies and practices during this period, see Sampson, Anthony. *The Seven Sisters: The Great Oil Companies and the World They Created*, Hodder and Stoughton : 1975. See also, Penrose (1968), op cit, chapter IV.
Arabia (1938), Kuwait (1938), and lastly Qatar (1939). However, before these discoveries could be made, the oil companies needed to secure the necessary contractual property rights that were required for pursuing the activities of exploration, development and finally the production of oil in that region.

The oil concessions were essentially a contractual agreement between an international oil company or a consortium thereof and an oil exporting state.

These concessions specified the award of the right of exploration, development, and the production of oil, natural gas and other associated products to the oil companies. These contracts defined ‘the grant, the area, the duration of the concession, the payments to be made by the concessionaire and, mostly in general terms, the mutual rights and obligations of the parties’.

The term concession, instead of the more usual oil lease, was used to indicate that at least one of the parties involved in the contract was the government. From the legal standpoint, the concessions could be regarded as

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10 Cattan, *ibid*, p2.
a hybrid of a public and a private contract. Most of the concessions concluded during the period upto 1960 had the following salient characteristics:\textsuperscript{11}

(1) The concessions covered large areas for exclusive operation, extending often over practically the entire territory of some countries such as Kuwait, Iraq, Qatar, Bahrain, Oman, the United Arab Emirates, or over vast tracts of some of the larger countries such as Iran or Saudi Arabia. Very often, provisions for the relinquishment of unexplored or undeveloped areas were not included or were left to the discretion of the concessionaires.

(2) They were of extremely long duration, stretching over several decades, with terms including fiscal terms, fixed rigidly.

(3) The concessions gave total discretion to the concessionaire in matters relating to the size, pattern and direction of activity in terms of exploration and drilling programmes, production levels, transport, refining, exports, etc.

(4) There was also complete operational freedom in the recruitment of expatriates, in the importation of goods and the construction of

\textsuperscript{11} Mikdashi, op cit, p.3.
separate residential enclaves with supporting infrastructure in the form of schools, hospitals, shopping complexes etc.

(5) The concessions envisaged the settlement of disputes outside the jurisdiction of the competent national courts of the host countries, through the process of international arbitration.

(6) In lieu of these rights, the concessionaires were required to make royalty payments, which constituted the principal financial transaction. The financial terms were extremely moderate. The royalty rate was fixed over the whole life of the concession and little or no flexibility was granted to the host government to allow it to raise the rate. These rates were based on either unit production or export, or the posted price of oil.

The manifest bias in these contractual arrangements in favour of the international oil companies is often sought to be established by comparing them with the oil leasing arrangements then prevalent in the United States. The US policy was designed to prevent monopoly exploitation of oil lands and for this purpose it incorporated the following salient features:¹²

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(a) Federal laws limited the area covered by exploration permits to 246,080 acres in any one state except Alaska where the limit was kept at 300,000 acres.

(b) The area that a prospector may lease after an oil discovery was limited to a quarter of the area covered by the prospecting permit with a minimum of 160 acres.

(c) The term of a lease was limited to 20 years.

However any comparison with leasing arrangements in the United States may not be strictly be in order in the first instance for the fundamental reason that the essential characteristics of the US leasing practices stemmed from the structure of ownership of the sub-soil, which is included as a part of the ownership of land.\textsuperscript{13} In the absence of private land ownership and the institution of modern landed property in the predominantly feudal economies of the Middle East, any contractual arrangement of this nature had to be between the Oil Company and the state.\textsuperscript{14} Further, prospects did not look attractive and on the contrary were perceived to be risky when the first


concessions were granted, there being no precedents of commercial level discoveries in these areas. A comparison with the US where much oil had already been produced is therefore not fully appropriate.

Having said this, it needs to be mentioned that the concession pattern remained virtually unchanged till the early 1950s even after significant discoveries of oil had been made in the Middle East. As Mikdashi has observed:

Royalty rates were based on either a unit of production or export, or the posted price of oil itself fixed unilaterally by the concessionaire. In a highly concentrated and vertically integrated industry with no competitive market for oil, the concessionaire could set the levels of production and exports of oil and their prices with a measure of discretion. This discretion implied that the concessionaire had a say in varying the receipts of the host countries. Several host countries were affected by that discretion in so far as they were heavily dependent on petroleum to finance the activities of the state and to develop the national economy.¹⁵

Further, the first oil lease granted in the US in 1857 before any oil had been discovered, gave the private lessor much more favourable terms than the Middle East government lessors in the first half of the twentieth century, both in terms of royalty or share in net profits - given the limited area of the land leased, its short duration (15 years) and the complete uncertainty that

¹⁵ Mikdashi, (1986), op cit, p.4
oil would ever be found. Also, most significantly, government levies in the US were the first charge on the oil produced, over and above the royalty or profit payments made by the lessee to the private lessor.\textsuperscript{16} In view of this, a scholar commenting on the pre-1970 concessions has characterised them thus: "Never in modern times have governments granted so much to so few for so long"\textsuperscript{17}

Although there were frequent disputes on the issue of profit sharing between the oil companies and the producing states, the essential structure of oil concessions remained virtually unaltered until 1970. A significant development in the 1950s, which was reflective of the growing political consciousness among the oil exporting nations and their concerns regarding a more equitable distribution of profits between them and the oil companies, was the introduction of the concept of 50-50 profit sharing.\textsuperscript{18} This arrangement envisaged an equal division of profits between the oil exporting states and the international oil companies. It marked an important departure from the early period of the concessions when a fixed royalty rate and a modest degree of profit sharing was the prevailing norm. The use of posted

\textsuperscript{16} ibid, p 6.
\textsuperscript{17} Stocking (1970), op cit, p 130.
\textsuperscript{18} For greater details on this concept, see Bina (1965) op cit, pp 25-27. See also, Yergin (1991) op cit, ch 22
price to determine the value of oil, that is a price that was devised for long-term oil transactions and contracts, and its linkage to the determination of oil royalties was a significant development of this period.

The 50-50 profit sharing arrangement was a prudent attempt by the oil companies to stem the tide of discontent in the oil exporting states. Having acceded to this new arrangement, however, the basic edifice of the oil concessions remained in tact. As Bina has observed:

On the other hand, there was little hesitation to go ahead with the new scheme of profit-sharing. As a result there was hardly any resistance by the international oil companies against 50-50 profit sharing, as long as there existed a framework for the determination of company profits. Of course, since the companies did not wish to expose their real profit picture by disclosing their detailed internal documents, they applied the notion of ‘posted price’ in order to solve the problem. The ‘posted price’ is a measure which was primarily used by the oil companies to value crude oil as it was transferred from one subsidiary to another within their own international network.19

In sum, although the first oil concession was obtained by D’Arcy in Persia under the aegis of British colonial domination at the very dawn of the twentieth century, the structure of contractual arrangements established became an integral norm for the international oil regime that was to emerge

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somewhat later. The concessions did undergo some modifications in the 1950s, particularly regarding the manner of profit sharing and the calculation of oil prices. However the basic structure remained unaltered till the early 1970s. This itself indicates that the concession norm had wide acceptance and any disputes concerning it were ostensibly resolved to mutual satisfaction.

The Creation of the Oligopoly

Until the year 1928, the history of the international oil industry was one of fierce competition for both markets and profits in which “every conceivable tactic was used, from price wars and bribery to violence”\textsuperscript{20} to secure competitive advantage. In the 1920s the former Standard Oil companies became genuine competitors and moved into each other’s territories. Competition was fuelled by large oil discoveries and the situation exacerbated by the decline in demand for oil due to the Great Depression of the 1920s resulting in crashing prices and squeezing of profits. Similarly competition was hotting up between Royal Dutch-Shell and the Standard Oil Company of New York (Socony) regarding the supply of Russian oil for markets in India and the Far East in the wake of the 1917 revolution and

\textsuperscript{20} Tanzer, \textit{op cit}, p, 25.
subsequent nationalisation of the former’s assets located in Russian territories. In late 1927, this threatened to develop into a full-scale price war. Against this background of cut-throat competition and increasing discomfiture of the oil companies involved, two significant agreements were entered among the major oil companies that sought to suppress conflict, limit damage and remove the need for retaliation. These agreements covered both the production as well as the marketing stage.

The Red Line Agreement

The Red Line Agreement has been characterized as “an outstanding example of a restrictive combination for the control of a large portion of the world’s oil supply.”\(^\text{21}\) The San Remo Treaty of 1920 had awarded a monopoly for oil concessions to the British and French in the mandated territories, of which Mesopotamia (later Iraq) held the greatest petroleum potential.\(^\text{22}\) The rising costs of production of oil in the US, primarily due to ageing wells, fuelled fears of prospective shortages of American oil. These fears were exacerbated what was perceived to be a growing monopolisation of overseas opportunities by British and Dutch companies. This prompted


\(^\text{22}\) Shwadran, Benjamin. The Middle East, Oil and the Great Powers, (John Wiley & Sons, 1973) pp 201-203
the US government to press for an 'Open Door' policy for the development of Middle East oil resources.\textsuperscript{23} In the wake of hints that oil exports from the US to Britain may be reduced (Exxon supplied 50 percent of the British market), intense negotiations commenced in 1922. Matters came to a head when a major oil discovery was made with the very first deep well drilled by the Iraq Petroleum Company (IPC) in 1927, without American Company participation. The final structure of the IPC was concluded in 1928 and its operating provisions came to be known as the Red Line Agreement, referring to a line drawn in red marker around most of the territories of the former Ottoman Empire.\textsuperscript{24}

In accordance with this agreement, the companies which operated the Iraqi oil concession (which had been joined that year by the two American companies, Standard Oil of New Jersey and Mobil Oil) committed themselves against participation in any projects for the production or marketing of petroleum, either directly or indirectly, except through the IPC, in the area defined by the red line on the map annexed to the agreement.\textsuperscript{25}

\textsuperscript{23} See Yergin (1991), op cit, pp 194-196.

\textsuperscript{24} ibid, p 203–206.

\textsuperscript{25} See Moran (1987) op cit, pp 580-583. Also Shwadran (1973), op cit. pp 237-238
The agreement remained in force until 1948 and had the significant impact of preventing the shareholders of the Iraqi concession, particularly the American oil companies, from competing among themselves for other concessions available in the Middle East. The common bargaining power of this group of companies also enabled it to obtain better conditions from the governments concerned. 26 There is also evidence that the Red Line Agreement actually restricted competition over the Saudi Arabian concession in 1933, and may have restricted competition in the purchase of Bahrain crude in the late 1930s. 27

It is significant to note that the US oil companies in the IPC were not enthusiastic from the start about the Red Line Agreement which severely restricted their movements, but were constrained to endorse it as a part of the price to be paid for their participation in the exploitation of Iraqi oil. In effect the Open Door policy implied that “once this group of Americans was inside, the Open Door would shut behind them.” 28 On the significance of the

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Red Line Agreement, One Writer Commented:

[The Red Line Agreement]...is an outstanding example of a restrictive combination for the control of a large portion of the world’s supply by a group of companies which together dominate the world market for this commodity.” And further, “The execution of the Red Line Agreement marked the beginning of a long-term plan for the world control and distribution of oil in the Near East. 29

The Achnacarry Agreement and the “As Is” System

The second major oligopolistic arrangement among the oil majors during the period between the two world wars was the Achnacarry Agreement, which essentially constituted an attempt to control the marketing stage. The three largest oil companies which constituted the so called Seven Sisters endeavoured to shield themselves from the centrifugal forces of competition by bringing themselves together “into a steadfastly collusive sales agreement”. 30

In the aftermath of the Russian revolution of 1917, the newly formed communist government seized the properties of Royal Dutch-Shell located in the territories of the Soviet Union. Throughout the early 1920s, both

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29 Blair (1976) op cit, p. 34.
Royal Dutch-Shell and the Standard Oil Company of New York (later Exxon) continued to purchase Russian oil which they sold in India and other markets of the Far East. After efforts to negotiate a compensation from the Soviet Union for its expropriated properties proved futile, Royal Dutch-Shell decided to move for a boycott of Soviet oil and asked Exxon to follow suit which the latter refused to accept. From the point of view of Exxon, such a step would have weakened its competitive strength since Royal Dutch-Shell was in a position to substitute the loss of Soviet oil by production from its concessions in Romania, while Exxon did not have access to a similar source of supply. When Exxon did not cooperate, Royal Dutch-Shell retaliated with a threat of price reduction of kerosene in India if Soviet oil entered Indian ports. The price reduction was carried out when Exxon proceeded to sell its Soviet oil triggering thereby a full-scale price war which ultimately began to spill over to the United States and Europe. At the beginning of 1928, however, attempts were made at the initiative of Exxon to forge an agreement that bring a halt to the internecine conflict. The international oil war ended with a formal armistice agreement, negotiated in 1928 at Achnacarry, Scotland, by the heads of Exxon, Royal Dutch-Shell and British Petroleum. The Achnacarry, or "As Is" agreement underscored the
willingness of the three companies to put an end to competition by accepting
the prevailing division of the oil market and agreeing to expand production
jointly. The agreement was based upon the following salient principles:

(a) the status quo of each member to be the basis for accepting and
    maintaining their share of the oil industry;

(b) existing facilities with each member to be made available to the other
    members on a favourable basis but at not less than the actual cost to
    the owner of the facilities;

(c) new facilities to be added only as actually needed to supply the
    increased requirements of the consumers;

(d) maintaining for each producing area the financial advantage of its
    geographical location;

(e) drawing supplies from the nearest producing area; and

(f) preventing any surplus production in a given geographical area from
    upsetting the price structure in any other area.\textsuperscript{31}

The extension of this arrangement to the other major international oil
companies in the early 1930s - the membership grew from three to eight and
ultimately many more - and a close observance of these principles

[especially principle (f)] by all participating companies, enabled the emergence of an international petroleum order based on tight oligopolistic control. Commenting on the operational effectiveness of this agreement, Moran has observed:

Like the Red Line Agreement, the system was masterly in easing the burden of establishing consensus among its diverse and disputatious participants. With regard to market shares, it took the distribution of sales in 1928 as a fixed point to begin dividing up world markets... As for prices, it evaded the task of reconciling differences among members with different preferred price targets. Instead, it took quotations as reported daily in Platt's Oilgram for US crudes on the Gulf coast of Texas; added freight rates from the Texas Gulf to any destination as reported in daily shipping journals; and produced a quotation for all sellers at the destination regardless of the origin of the oil (the "Gulf-plus" formula). The base price was not an artificial construct... rather, it derived from a genuine arms-length market (albeit served by high cost producers), which varied in response to cyclical changes, substitution, and long term elasticities of demand and supply. Generating uniform c.i.f. prices, it was much easier to administer than a system of (presumably) uniform fob prices... Once set in place, the price formula required no further active collaboration. 32

The Instructional Agreements

Having agreed on general principles, the companies subsequently entered into a series of three further agreements, delineating in progressively greater detail the functions of the local cartels to be set up in various individual consuming countries: the Memorandum for European Markets (Jan 20, 1930), the Heads of Agreement for Distribution (Dec. 15, 1932), and the Draft Memorandum of Principles (Jan 1, 1934). The principal issues that these agreements covered were: (a) fixing quotas; (b) making adjustments for under- and over trading; (c) fixing prices and other conditions of sale; and (d) dealing with outsiders.

The Memorandum for European Markets followed the Achnacarry Agreement in specifying 1928 as the base period for the determination of quotas, which were to be allotted for each petroleum product sold in the country. Quotas could be increased, but only at the expense of “outsiders” i.e., firms not parties to the agreement. To ensure compliance with the quotas, the parties were to meet and report their own deliveries as well as giving estimates of total “outside” deliveries as a basis for determining the total consumption of each local market area. In the Heads of Agreement for

33 Blair (1976), op cit, p 56.
Distribution, these provisions were carried forward. Not all of the parties had complete faith in the integrity of their rivals, since the trade figures submitted by each of the companies had to be certified by an independent auditor. The Draft Memorandum of Principles set forth in great detail the precise rules to be established governing revision in quotas in a variety of circumstances.\(^{34}\) The Draft Memorandum of Principles also incorporated a yardstick for price determination - prices were to be maintained in all markets on a basis, which should yield a fair return on a reasonable investment.\(^{35}\)

Anticipating the need for some central authority to iron out differences that could not be resolved at the national level and to meet still further contingencies that were difficult to anticipate, the oil majors in the Heads of Agreement for Distribution agreed that “to further the smooth working of ‘as is’ a central full time secretariat should be formed, with its functions to be divided between New York and London committees....”\(^{36}\)

\(^{34}\) ibid, p 57.

\(^{35}\) ibid, p 60

\(^{36}\) ibid, p 62.
Long-Term Supply Contracts

The manner in which the petroleum industry evolved at that time, there was always a likelihood of a mis-match developing between the volume of crude oil being produced by any particular major oil company and the refining capacity and distribution network under its direct ownership and control. This was always a possibility in the wake of a large oil discovery and had the potential of severely disrupting the carefully crafted oligopoly.

The integration of Kuwaiti production in the wake of a huge oil discovery jointly by British Petroleum and Gulf oil in 1938 represented the first major challenge to the international oil regime during the post war period. The desire of the companies to eliminate competition amongst themselves and to coexist peacefully without disrupting the existing price structure, was the driving force behind the long-term sales contracts signed first by Gulf Oil with Royal Dutch-Shell and thereafter by British Petroleum with Exxon and Mobil. Under these contracts, Gulf Oil agreed to supply Royal Dutch-Shell more than 1.5 billion barrels of Kuwaiti crude over a period of at least 22 years and in the other contract, British Petroleum agreed to provide Exxon with 1.3 billion barrels of crude over a 20-year period. At the time, these were the largest petroleum contracts ever concluded in history. Regarding
the pricing arrangements envisaged in these contracts, which were both innovative and unusual, Moran has observed:

In the end, both buyers and sellers compromised on a contract price between cost and final sales price, each making losses relative to what pure profit maximisation within the As Is framework would have been in the absence of the contract. BP and Gulf gave up a portion of the revenues they could have had if they sold the oil on their own. Exxon, Royal Dutch-Shell and Mobil gave up a fraction of their market share to the new producers in Kuwait. To find the larger meaning for signing these huge contracts (thereby inflicting losses on themselves as well as on each other), one must search beyond the simple profit motive. From the buyer’s point of view, the long-term contract gave him control over the marketing of a large amount of the new Kuwaiti crude; he could supervise directly to see there was no price cheating. From the seller’s point of view, the long-term contract gave him control over a large amount of new Kuwaiti production facilities. Without the long-term contracts, the parties had only their word to bind them to the Achnacarry agreement. With the long-term contracts, they had the corporate equivalent of an exchange of hostages.\textsuperscript{37}

Commenting on these arrangements, the report on the International Petroleum Cartel states:

Thus the crude oil supply contracts, not only because of the large quantities of oil and the long periods of time that were specified, but also because of the unusual provisions as to price and marketing, constitute effective instruments for the control of Middle East oil. As such, they complement and increase the degree of joint control over Middle East oil resulting from the

\textsuperscript{37} Moran (1987), op. cit. pp 586-587.
pattern of joint ownership...The operation of these two instruments of control, in effect, brings the seven international oil companies, controlling practically all of the Middle East oil resources, together into a mutual community of interest.38

Through these wide ranging agreements backed up and enforced through detailed procedures, dispute resolution and co-ordination mechanisms, the seven major international oil companies came to acquire a vice-like control over the international petroleum system. By 1946, these seven oil companies had come to control around 90 percent of the world’s oil production outside of the US and USSR as shown in the table below:

**TABLE 1: Share of the Seven Sisters in international oil production.**

<table>
<thead>
<tr>
<th>NAME OF COMPANY</th>
<th>PRODUCTION (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EXXON</td>
<td>28</td>
</tr>
<tr>
<td>BRITISH PETROLEUM</td>
<td>22</td>
</tr>
<tr>
<td>ROYAL DUTCH-SHELL</td>
<td>21</td>
</tr>
<tr>
<td>GULF OIL</td>
<td>9</td>
</tr>
<tr>
<td>MOBIL</td>
<td>5</td>
</tr>
<tr>
<td>TEXACO</td>
<td>3</td>
</tr>
<tr>
<td>CHEVRON</td>
<td>2</td>
</tr>
<tr>
<td>TOTAL</td>
<td>90</td>
</tr>
</tbody>
</table>

Source: Moran, Theodore “Managing an Oligopoly of would be Sovereigns”, *International Organization* 41,4, Autumn 1987, p 585

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38 *International Petroleum Cartel*, op cit, p 162.
A better appreciation of the magnitude of the wide-ranging activities of the seven oil majors in the different stages of the oil business can be had from the following table:

**TABLE 2: Activities of the Seven Sisters in different stages of the oil business around 1950 (as a percentage to total activity).**

<table>
<thead>
<tr>
<th>Activity</th>
<th>Middle East</th>
<th>Eastern Hemisphere</th>
<th>Western Hemisphere</th>
<th>World</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership of crude oil reserves.</td>
<td>65</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Production</td>
<td>99</td>
<td>96</td>
<td>45</td>
<td>50</td>
</tr>
<tr>
<td>Refining Capacity</td>
<td>79</td>
<td>75</td>
<td>57</td>
<td></td>
</tr>
<tr>
<td>Cracking capacity</td>
<td>84</td>
<td>53</td>
<td>55</td>
<td></td>
</tr>
<tr>
<td>Transportation</td>
<td>50</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


**Vertical Integration**

In order to sustain the international petroleum order created by the major international oil companies, the companies consciously pursued a strategy envisaging vertical integration of business functions; namely, a control of activities starting from the exploration and production of crude oil to its transportation, refining and processing and ultimately its distribution to end consumers. The economic advantages stemming from integration in the oil
industry have been succinctly listed by Edith Penrose, an oil economist of international repute, as being the following:

(a) assured outlets for crude, leading to a steadier and more efficient planning of output over time;

(b) more efficient operation of refineries as a result of an assured and managed flow of crude oil;

(c) a more flexible and efficient adjustment to short run changes in the demand for different products in different areas, which can be quickly reflected in the inflows of crude oil; and

(d) a consequent avoidance of disruptive fluctuations in prices which would raise costs to both consumers and producers.39

The fact that till around 1970, vertical integration was a well-established norm of industrial organisation in the international petroleum industry can be gauged from the fact that all the major international oil companies were vertically integrated. Commenting on the organisation of the international oil majors in the post World War II period, Penrose has observed:

They are all vertically integrated, operating at all stages of the industry beginning with the exploration for and production of crude oil and ending with the distribution of the finished product to the final consumer; The integration of the

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39 Penrose (1968), op cit, pp 46-47
Companies extends across national frontiers, and crude-oil production outside the US is concentrated in areas in which both consumption and refining are relatively small. *It is widely held that extensive integration is a necessary condition for the efficient operation of the industry particularly integration of crude-oil production, refining, and distribution.* *(Emphasis added)*

A high degree of vertical integration was necessary not merely for exercising the oligopolistic control of the major oil companies but also for maximizing retained profits. As Penrose has observed:

> For an integrated Company, the price at which crude oil is transferred producing to refining affiliates determines the distribution of its total profit between crude production and refining. For any given level and structure of product prices and costs, the higher the transfer price of crude oil, the lower the profits attributed to refining and distribution, but total profits (before tax) are unaffected by the internal (accounting) distribution of profits.41

A high degree of integration enabled the oil companies to be arbitrary in allocating costs to different operations and in setting the prices for the transfer of goods and services between subsidiaries. In this fashion the international oil firms juggled their overhead costs and adjusted transfer

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40 Penrose, *ibid*, p 46.

prices among their foreign branches and affiliates in such a way as to reduce their total tax outlays. Since the revenues of the oil producing states depended crucially on the ‘posted price’ of crude produced, any reduction in this price would adversely impact on their earnings. It would, however, leave corporate profits unaffected since such reduction would correspondingly boost the profits of the refining affiliates. As already discussed, vertical integration also enabled the major companies to conclude long term contracts under which they sold each other large quantities of crude oil at low, or flexible prices and at conditions agreed upon amongst themselves.

As Mikdashi has observed:

A company can obtain fiscal advantages, thanks to its transnational spread, by crediting losses of one affiliate against the profits of another and by setting ‘appropriate’ transfer prices for raw materials, processed products, services, technology, and so on. Indeed, in the absence of ‘arm’s length’ open market prices and barring legal interdictions, the transnational vertically integrated company is naturally prompted by a wish to price inter-affiliate transactions in such a way as to reduce overall tax burden, by attributing the lowest possible profit margins in high tax countries and the highest possible profit margins in the low tax or tax-free countries. Such manoeuvrability is not accessible to the ‘independent’ companies: their activities are mostly limited to one country

and/or one kind of operation (for example, production, transport, refining or marketing).

Vertical integration thus served as an effective entry barrier as the lack of vertically integrated channels was a major competitive disadvantage to those oil companies that did not have them. “When faced with competition, [the international oil majors] could respond by manipulating the relative prices of crude oil and products in order to squeeze the profitability of competitors who were not vertically integrated”. The logic of vertical integration thus extended beyond the pale of purely efficiency and management considerations. It was a functional necessity both for exercising oligopolistic control over the international petroleum system as well as for maximizing retained profits, net of taxes, of the major oil companies.

The pervasive oligopolistic control exercised by the seven international oil majors in the first oil regime is well summed up in the following quote from the International Petroleum Cartel:

The international oil industry, in a physical sense, is composed of four distinct and separate divisions: production (and exploration), transportation, refining, and marketing. However, by vertical integration, the operations in all divisions are performed by large integrated companies.

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44 Philip, George. The Political Economy of International Oil (Edinburgh University Press, 1944), p. 46
Control over the international oil industry is largely in the hands of seven integrated companies. Outside the United States and the Soviet Union, they control the bulk of production and marketing of oil moving in international commerce. Many pairings and groupings of these seven companies and their affiliates conduct joint operations in most parts of the world. Four of them own over 70 percent of the shares of Iraq Petroleum Co. Ltd., which, in turn, controls all the oil of Iraq, Qatar, the Trucial coast, and other less important areas in the Middle East; four of them own all the shares of Arabian American Oil Co., which controls all the oil in Saudi Arabia, and two of these four own the Bahrein Petroleum Co. Ltd., which, in turn, controls the oil resources of Bahrein Island; one has exclusive control of all the oil in Iran, and in partnership with another of the seven companies, controls all the oil in Kuwait; three of the seven, in partnership and in separate operations, control most of the oil resources of Venezuela and other Latin-American countries, except those with state monopolies; five of them, operating as three corporate entities, control most of the oil resources of the Netherlands East Indies.

These seven international companies operate through layers of jointly owned subsidiaries and affiliated companies. Through this corporate complex of companies, they control not only most of the oil but also most of the world's foreign petroleum refining, cracking, transportation, and marketing facilities. Thus, control of the oil from the well to ultimate consumer is retained in one corporate family or group of families.

Joint ownership of affiliated companies is probably more widespread in the international petroleum industry than in any other field of enterprise. The major international oil companies use the joint-ownership technique not only in conducting foreign operations but also in their operations in the United States and Canada. This is particularly true with respect to control of pipe lines and companies holding patents on technological processes. Thus, the international companies, operating in the United States and Canada, are joined with the larger domestic oil companies in the two operations where
control is likely to exert the maximum of influence on the industry.

Also, the board of directors that manage the myriad of jointly owned corporations may, in effect, be private planning boards where differences are resolved and where an oil policy for the world can be established. Under any circumstances, it would be difficult to over-look the significance of the meeting together of directors of the major international oil companies to determine the price and production policies of companies whose operations must inevitably affect the oil industry throughout the world.

Control through the joint-ownership device is further centralized and unified by the fact that directors of the major companies also serve as directors of some of the more important affiliated companies. This close association of policy-making officials can readily result in a unified management of the various combinations of interests, and thus tends to lessen the opportunity for effective competition between the major companies in their foreign operations.

The international companies have also extended their spheres of potential influence over the United States oil industry through indirect interlocking directorates. Although the association of the directors of the international companies with the directors of important domestic oil companies on the board of a third company may not be significant in and of itself, it at least provides the opportunity for reconciling differences that may arise between the international and the domestic companies.

The significance of this high degree of concentration for the cartel problem lies in the fact that concentration facilitates the development and observance of international agreements regarding price and production policies. Indeed, the concentration of an industry into a few hands may be regarded
as the sine qua non of effective cartel operations.⁴⁵

The Political Canvas

Having described in some detail the dominant norms and principles of the First Oil Regime, it would be necessary, before concluding this chapter to analyse briefly the political power structure in which this regime was ‘nested’. The following quote from Lawrence P. Frank succinctly portrays the political context of the Regime:

The first oil regime was controlled by Britain, the United States, and the great energy corporations known as the Seven Sisters. Together, they developed procedures to regulate the production rates and price levels of petroleum. Although this regulation was primarily conducted by consortia of private firms, it was based on the domination of the Middle East by Anglo-American political and strategic power. The regime served both national and corporate interests by providing a secure source of plentiful and cheap oil.⁴⁶

Commenting on the control exercised by the major integrated oil companies over the production, transportation, processing and marketing of oil from the Middle East and other oil-exporting areas, Robert O.Keohane has observed:

⁴⁵ International Petroleum Cartel, op cit, pp. 32-33

"State power played an important role in assuring that control, which rested both on America’s special relationship with Saudi Arabia and on the ability and willingness of the United States and Britain to intervene in defence of their petroleum interests...."^47

Though a regime, in the formal sense of the term, could be said to have come into existence only after the Red Line and Achnacarry Agreements of 1928, the 32 year period following the end of the First World War (1918-1950) was a period of relatively unchallenged control by British, American and corporate power over the production, processing and distribution of petroleum. The internal distribution of power among the major actors however underwent a shift over this period in two significant directions. The first was the decline of the British Empire after the First World War and the rise of the United States to the centre stage of world politics. The second development was the increase in the autonomy of corporate power vis-à-vis the states. According to Frank:

"These two adjustments were closely related. Although the United States became the stronger of the two powers, it was weaker vis-à-vis the corporate

enterprises. During the apex of American hegemony, private capital dominated world oil as never before or since.”

In the aftermath of the First World War and upto around 1930, Britain continued to be a major player, although it was badly overextended, particularly in the Near East. The imperial strategy was to bolster its militarily weak position by means of indirect rule in the empire, and by persuading the United States to assume responsibilities commensurate with its wealth and advantaged position. As Frank has observed:

In trying to piece together a group of dependants and allies, the British used oil as the prime instrument. By controlling and awarding access to Iraqi oil, Britain constructed a political order that remained centred on England. Thus strategic issues rather than economic ones dominated the politics of oil at this juncture.

The instrument that the British used for this purpose was the Turkish Petroleum Company (later known as the Iraq Petroleum Company) which was “a consortium of British, Dutch, and German capital which had acquired purported oil rights in Iraq before the war” from the government of the Ottoman Empire. Although the T.P.C’s post war claim to Iraqi oil was

48 Frank, op cit, p.588
49 ibid, pp. 588-589.
widely regarded as being dubious, the British chose to recognise and reconstitute the company in the pursuit of larger strategic interests in the Middle East. In response to US protests regarding non-inclusion in the consortium, the British recognised “that an injection of US capital into Iraq would serve the larger interests of British policy there.”\textsuperscript{51} In contrast the US State Department’s “exertions came at the behest of private parties, who in fact held the practical initiative on the American side.”\textsuperscript{52}

The British used the T.P.C. to carefully craft a strategic alliance, the stability of which was strengthened by consciously providing the governments of Iraq and Turkey with vested interests in the new order. Thus, when negotiations between the T.P.C and the mandate government of Iraq began in 1923, “advisers from the [British] Petroleum Department and the Colonial Office helped the Iraqi finance minister formulate a remarkably tough bargaining stance.” Later, “Whitehall intervened repeatedly to force the company to yield before Iraqi demands.”\textsuperscript{53} It was abundantly clear that British policy placed strategic interests in terms of ensuring the stability of its client state on par with the commercial aspects of the arrangement.

\textsuperscript{51} ibid, p.91

\textsuperscript{52} ibid, p. 113.

\textsuperscript{53} ibid, p.88
By 1928, Britain had reconstituted the T.P.C. into an elaborate mechanism binding together the major actors, both Western and local, in the region. However, while Britain distributed oil and royalties to its partners, it retained essential control of the regime. Thus, “the Iraqi oil fields had a commercial importance to be sure. But for the statesmen whose major concern was preserving the British Empire, the strategic significance of holding the oil territory was the essential issue.”

It will be clear from this that while private actors may have wanted to define their priorities and interests differently, the British state was able to successfully impose its views on the other actors, both states and corporations. While accommodating corporate interests as well as interests of other states, British strategy was to ensure that it remained the central actor. An excellent example of this strategy was the Red Line Agreement of 1928 under which the members of the consortium comprising the T.P.C. imposed upon themselves the self denying regulation that no member would procure concessions in any other part of the former Ottoman Empire except under the umbrella of the T.P.C. The agreement clearly worked to the commercial disadvantage of the strongest company, Anglo-Persian (later

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54 *ibid*, p. 105.
British Petroleum) which was 100 percent British owned. However government pressure was used to ensure that the agreement went through.\textsuperscript{55}

In sum, "British oil policy in the Middle East after World War I exhibited a consistent strategy, a clear set of priorities and state control of corporate actors."\textsuperscript{56}

The US policy in the Middle East, only a decade later, was a study in contrast. Before the Second World War, the United States State policy had focused primarily on securing access for US oil companies to the concessions in the areas dominated politically by Britain and France. It was because of these efforts that participation of American oil companies was secured in the Turkish Petroleum Company as a part of the Red Line Agreement. During the 1930s, a number of significant oil discoveries were made in the Middle East and elsewhere. However, from the long-term international standpoint, the most important discovery was made in Saudi Arabia in 1938 by the California Arabian Standard Oil Company or Casoc (later known as Aramco), a jointly owned subsidiary of two American oil companies, Socal and Texaco. In 1940 these fields were already producing

\textsuperscript{55} Ibid, p. 129.
\textsuperscript{56} Frank, op. cit., p 590
five million barrels of oil and by 1941 both the companies involved and the Saudi monarchy realised that the magnitude of the petroleum reserves in the area could be substantial.\textsuperscript{57}

During the War, US policy makers came to realise that the United States would soon become a net importer of oil. Concerned about the rapid depletion of domestic oil reserves during World War II and aware of the large deposits of oil in Saudi Arabia, the United States began pursuing an activist policy in the Middle East.\textsuperscript{58} Policy makers in Washington advanced three different schemes in 1943 and 1944 with the objective of developing Saudi Arabian oil resources under US control so that oil could be made available to the US military in case of emergency and to European markets in normal times, thereby decreasing the demands on Western Hemisphere reserves. The three policy initiatives consisted of the following:

(a) an attempt by the U.S.Government to purchase stock in Casoc which controlled Saudi oil; (b) negotiation of an Anglo-American Petroleum Agreement designed to regulate the production of oil in the Middle East; and (c) the construction of a trans-Arabian pipeline by the U.S.Government.

\textsuperscript{57} For a detailed account of these developments see Shwadran (1973), ch xv.
\textsuperscript{58} See Yergin, \textit{op cit}, pp 395-398.
All the three initiatives came to naught and the complex history of why this happened is detailed in two excellent works covering roughly the same material by Anderson (1981) and Stoff (1980). The precise details need not concern us here; what is significant is that both works reach the same conclusion that US Middle East policy during this period was driven more by oil interests than by public authority. Commenting on the US policy towards Saudi Arabia, Anderson states:

This policy was not one arrived at by strong executive leadership (as the Constitution suggests that it should be) or by political debate within a duly elected body. Instead, it was the product of competing interest groups in and out of government finally reaching a compromise and resolving themselves into a coalition that appeared to serve each of their special interests. As should be abundantly clear from the events of late 1944 and early 1945, the government agencies involved were the weaker partners in the coalition...”(Emphasis added)

Stoff’s view is more explicitly critical. He argues that the security achieved by US policy in the 1940s, through unregulated arrangements with private companies was gained at high cost:

The opportunity to shape a coherent national policy for foreign oil was lost. Through the Petroleum Reserves Corporation and


61 Anderson, op cit, p 204.
more widely through the Anglo-American Oil Agreement, government planners had attempted to institutionalise public responsibility over oil in order to influence its development and distribution for the good of the nation, as those planners saw it...The effort failed...[American oil companies] became the agents of national policy because they could get the job done without the strains of public initiatives. The interests of those companies and of the United States government coincided in the first years after the war, as they had during it. But there was no guarantee that they would continue to do so. In the long run, private companies might find profit in commercial arrangements that worked against what public representatives determined as national interests.”(Emphasis added)\(^62\)

Comparing US oil policy with that of the British, Frank states:

“The failure of the United States to gain power over CASOC and the Arabian oil that it controlled presents a striking contrast to the British government’s manipulation of the Turkish Petroleum Company and Iraqi oil. The American government was less capable than the British of acting autonomously. The biggest handicaps the US faced appear to have been its pluralist structure and wide diffusion of power among private and public actors.”\(^63\) In addition, “the private oil interests successfully mobilised opposition to the government’s plans to ensure secure oil supplies by

\(^{63}\) Frank, op cit, p 594
appealing to the general fear of oppressive state power.” And “the State Department never doubted that the national interest could be equated with maximum latitude for private enterprise and minimum governmental intervention in the world economy.”

From the foregoing discussion some broad conclusions regarding the relationship between regime and state power can be attempted. Was the First Oil Regime a mere handmaiden of state power, as the realists would have us believe? Or did the regime come to acquire a measure of autonomy of its own with the regime’s major corporate actors often crucially influencing the direction of state policy? It is clear that the relationship between the regime and hegemonistic state power underwent a significant transformation over time. During the early part of the regime when British State power was dominant, commercial objectives were made subservient to the larger goal of furthering British strategic interests in the Middle East. During the latter part, the United States gained hegemony. On account of its highly pluralistic governmental structure, diffusion of power and ideological orientation, the American State permitted a far greater degree of regime autonomy than the British State had. In fact, as noted by Stoff, “oil companies were hospitable

64 ibid, p 595.
only to the species of government meddling that comes at the invitation of business and quickly falls under this control."65

The growing dominance of American owned companies and the consequent decline of British power in the international oil system during the period 1938-1953 can be gauged from the following table:

**TABLE 3:** Control by major powers in key producing areas outside the United States and the Soviet Union, 1938-1953 (in percentage)

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>1938(%)</th>
<th>1945(%)</th>
<th>1953(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>UNITED STATES</td>
<td>33</td>
<td>41</td>
<td>53</td>
</tr>
<tr>
<td>BRITAIN&amp;HOLLAND</td>
<td>53</td>
<td>41</td>
<td>33</td>
</tr>
<tr>
<td>OTHERS</td>
<td>14</td>
<td>18</td>
<td>14</td>
</tr>
</tbody>
</table>


The control of British owned companies over production outside the United States and USSR eroded from 53 percent in 1938 to 33 percent in 1953, the loss being correspondingly picked up by the US companies. This laid the foundation for a US dominated world oil order till around 1970.

US Government support for this regime was explicit and unequivocal over this period. The nature of this support, however, underwent a distinct albeit subtle change over time. In the beginning the US government actively intervened in pursuit of securing corporate interests. For example, the State

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65 Stoff, *op cit*, p 27.
Department had a direct hand in the negotiations concerning the abolition of the Red Line Agreement which had seriously hemmed in the operations of the two American companies, Exxon and Mobil Oil. Thus when an opportunity to participate in the Aramco concession in Saudi Arabia presented itself in 1946, both the companies renounced their commitments under the agreement, ignoring the strong protests of the other parties. The matter was resolved after protracted negotiations in which the State Department was actively involved and the two companies were allowed to participate in the Aramco consortium.\(^{66}\)

The State Department also indirectly intervened in the modifications of the Gulf-plus pricing system that in effect had subsidised US crude-oil exports for nearly two decades.\(^{67}\) The application of this rule meant that crude oil, irrespective of its origin, was considered for pricing purposes as if it had originated in the Gulf of Mexico, and was priced on the basis of prices prevailing in that Gulf, regardless of its location or cost of production. This was a unique device to link the price of low cost oil produced in the Middle East with the price of the high cost oil in the United States, by adopting a

\(^{66}\) See Yergin (1991) op cit, pp 413-419 and Shwardan (1973), pp 243-244.

single basing-point system or 'Gulf Plus'. After World War II, in order to end the discrimination between the f.o.b. prices to London and New York City, the price of Middle Eastern crude was set by a netback formula.68

The CIA involvement in the overthrow of Iranian Premier Mossadeq in 1954 marked the end of United States interventionism in the oil system for nearly two decades.69 The US hegemony over the international oil system manifested itself in what has been characterised as a “guided laissez-faire regime.”70

We now propose to sum up the main conclusions of this chapter. We have asserted that an informal non-contractual regime was established in the international oil system in 1928 with the following dominant norms: (a) the system of concessions which constituted the contractual arrangements between the oil companies and the oil producing states, determining the property rights concerning the exploitation and production of oil and the distribution of net profits among the contracting parties; (b) oligopolistic control of the oil system by the major oil companies exercised through an


elaborate set of agreements and procedures aimed at eliminating intercorporate competition and minimising internecine conflict; and (c) a vertically integrated form of industrial organisation for the oil majors. The regime was established with the active involvement of Anglo-American State power, with British colonial power dominant in the early stages. The period of British domination was characterized by direct state intervention and primacy being given to British strategic interests over purely commercial ones. The rise of American hegemony over the international oil system witnessed a transformation in the relationship between regime and state power. American hegemony was much more concerned with the pursuit of corporate interests than purely strategic ones and especially after the coup in Iran in 1954 American policy entered a phase of “guided laissez faire” vis-à-vis the oil regime while providing it with unequivocal support.