CHAPTER THREE: THE PATH TO REGIME CHANGE

The First Oil Regime survived relatively unscathed till the first ‘oil shocks’ of the early seventies. However, it’s dominant norms and its *raison d’être* had begun to be questioned much earlier. All the regime participants had undoubtedly benefited from the arrangements, which had provided the international petroleum system with a great degree of predictability and stability. In fact it could be averred that ‘predictability and stability’ were the most significant and uncontroversial collective goods to be produced by the First Regime. However, serious dissatisfaction developed over time over the distribution of regime benefits, which were perceived to be heavily skewed in favour of the oil companies, their sponsoring governments and the oil consuming countries. These were fuelled by the anti-colonial ideological ferment after the Second World War and the growth of nationalistic movements in the oil producing countries. The nature of the oil market also underwent a major transformation towards the late sixties, resulting in the emergence of a seller’s market. These factors along with the emergence of OPEC as an important forum for promoting unity and co-ordination of interests of the oil producers ultimately led to the collapse of the old order in the early seventies. We propose in this chapter to describe and analyse the
major developments which led to the collapse of the old regime and the emergence of a new one. In this process we will also attempt to draw some broad conclusions about the process of regime transformation and how well these square up with the mainstream thinking on this issue.

Under the First Regime in the words of Keohane:

"A remarkably stable system of relationships evolved, which provided the companies with ample profits and enabled consumers in industrialised countries to import petroleum at declining real prices."¹

It would, however, be misleading to imagine that the relationship between the companies and the oil producing states was only exploitative in nature. Although the distribution of benefits emerging from the regime was undoubtedly weighted in favour of the oil majors, the relationship was productive for the oil producing nations as well.

In the first place, the oil companies brought with them the technology, knowledge and skills which enabled the exploration and production of oil in the host countries. Second, they supplied the large amounts of risk capital necessary for the exploration and development of oil, which most certainly

in the initial stages was beyond the financial capacity of the oil producing states. Third, the companies managed all the functions involved in the manufacture of petroleum, from exploration and production to processing and transportation, and finally distribution to the ultimate consumers, a task which was beyond the capacity of the oil producing states, not only during the existence of the First Regime, but even long after it had collapsed.2

The Fifty-Fifty Principle

One of the major points of friction arose from the nature of the early concessions that were signed with the producing countries, especially on the issue of the division of the rents arising from the production of oil. The early concessions made a provision for the payment of royalty at fixed rate based on the volume of production or export. There was also a provision for the sharing of profits, although the framework for the determination and assessment of profits was always in dispute in the absence of complete and reliable information being provided by the companies to the producing countries. As Yergin has commented:

In the late 1940s and early 1950s, oil companies and governments grappled continually over the financial terms upon which the post-war petroleum order would rest. The central

issue was the division of what has been called ‘that uneasy and important term in the economics of natural resources’- rents. The character of the struggle varied among countries, but the central objective of those initiating the struggle in each country was the same: to shift revenues from the oil companies and the treasuries of the consuming countries that taxed them to the treasuries of the oil exporting countries.³

The first dent in the old pattern of concessions was made in Venezuela where Exxon and Royal Dutch-Shell were the dominant producers. In the face of a nationalistic upsurge in that country demanding wholesale revision in the contractual terms between the government and the oil companies, the latter were loathe to risk the possibilities of nationalisation. The US government was also most keen on preserving its access to Venezuela which was its major source of low cost oil. All the major actors involved were thus in favour of working out a settlement which was in the event hammered out in 1948 on the new principle of ‘Fifty-Fifty’. According to Yergin:

It was a landmark event in the history of the oil industry. According to this concept, the various royalties and taxes would be raised to the point at which the government’s take would about equal the companies’ net profits in Venezuela. The two sides would, in effect, become equal partners, dividing the rents down the middle.⁴

⁴ibid, p 435.
It is relevant to mention here that about this time the government of Venezuela was also getting concerned about the substantial increases in the production of oil in the Middle East where the cost of production was low, at the expense of reduced production within its own borders. In the perception of the Venezuelan government, the primary reason for this unprecedented increase in the production of low cost oil in the Middle East was the prevailing political and economic climate in these countries which allowed the international companies virtually unfettered freedom of operations with minimum financial obligation.⁵

With the objective of increasing the political and economic awareness of the Middle Eastern countries relating to the issues involved in the exploitation of oil, the Venezuelan government sent a number of missions to these countries in 1949. In the words of Ahrari:

“Venezuela hoped that, once these governments became aware of the 50-50 profit-sharing system, the inordinate competitive advantage enjoyed by Middle Eastern oil would be lessened, thereby easing the downward pressure

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on Venezuelan production.”

It was not long before negotiations started between the governments of the producing countries in the Middle East and the oil companies concerned. An agreement introducing the 50-50 sharing system was concluded in Saudi Arabia by the close of 1950, and this example was emulated by Kuwait and Iraq soon thereafter. In the words of Yergin:

The Saudi-Aramco Fifty-Fifty agreement of December 1950 was, with justification, described as a ‘revolution’ by one historian of the decline and fall of the British empire - ‘an economic and political watershed no less significant for the Middle East than the transfer of power for India and Pakistan.’ As for the American government, it satisfied the urgent and critical need to increase the income to Saudi Arabia and other governments in order to maintain the post-war petroleum order and to keep those ‘friendly’ regimes in power. The stakes and risks were enormous. (Emphasis added)

The Developments in Iran

The introduction of a 50-50 profit-sharing regime in Saudi Arabia intensified pressure for a similar agreement in Iran. Towards the end of 1950, a special committee of the Iranian Majlis (parliament) chaired by Dr. Mohammad Mossadeq, initiated a study of nationalisation. Assessing the

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7 Yergin (1991), op cit, p 448.
public mood and the portents in the air, the Anglo Iranian Oil Company (AIOC) which managed the Iranian concession, concluded an agreement with prime minister Razmara, the details of which were kept secret. The prime minister waged an intense campaign against the rising demand for the nationalisation of the Iranian concession, but was assassinated in March 1951 following which the Majlis voted for nationalisation. Soon thereafter, Dr. Mossadeq became the Prime Minister and Shah Mohammed Reza Pahelvi, the young son of the deposed Reza Shah was forced to accord his assent to the parliamentary action. The measure became law on the first of May 1951. 8

For Britain, the nationalization episode in Iran drove home with full force the unpleasant reality of its rapidly declining power in the post World War II world. For the AIOC, the event was a clear indicator that the concession regime may not survive very much longer in its existing form. However, given the high stakes involved, neither Britain nor the AIOC were prepared to go gently into the night. After the International Court at the Hague had refused to accept jurisdiction of this case, the British government and the AIOC settled on a two-pronged strategy of instituting an economic boycott

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8 For a detailed account of these developments, see Shwadran (1973), Ch.V.
of Iranian oil and bringing intense pressure on other importing governments to refrain from purchasing petroleum products from Iran. In addition, as a measure designed to offset the loss of oil revenues from Iran, the AIOC substantially stepped up its production from the oil fields of Kuwait.

These actions by themselves did not bring about the fall of the Mossadeq government as had been anticipated. The Iranian economy was not heavily dependent on income from the oil sector and therefore the collective actions of Britain and the AIOC only made it hard for Iran to sell its oil but did not bring down the Mossadeq government. Mossadeq’s downfall is attributed to several other factors such as the alienation of the Iranian upper classes on account of the harsh measures taken by him to collect taxes; his battle with the Majlis for the grant of powers to him to govern by decree for one year and the refusal of the Majlis to accede to this demand; the clashes between him and the Shah for the control of the army turning into a full fledged power struggle\(^9\) culminating with his overthrow with the active connivance of the Central Intelligence Agency.\(^{10}\)

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\(^9\) For a detailed account, see Shwadran, op cit, pp 109-120.
\(^{10}\) The details of this episode are well documented in David Wise and Thomas B. Ross, *The Invisible Government* (New York, 1964).
The restoration of the monarchy in Iran also brought to the forefront the issue of the revival of the old concession. A new consortium was forged with the active involvement of the American and British governments which added seven other companies to AIOC (which itself changed its name to British Petroleum Company). The newly joined member companies were Royal Dutch-Shell, Standard Oil of California, Exxon, Texaco, Mobil Oil, Gulf Oil Corporation and the French company Compagnie Francaise des Petroles (CPF). These companies along with AIOC were members of the joint ventures that produced oil elsewhere in the Middle East and were thus responsible for most of the oil production from this area.\textsuperscript{11} During the years that Iran had been out of the world market, production from the neighbouring countries had increased dramatically and it was self-evident that if the rising output was to be curtailed somewhat to make room for the revival of Iranian exports, all the seven major companies operating in the region would need to be given a stake in the new Iran consortium.\textsuperscript{12}

While it is significant that the creation of the consortium did not in principle reverse the nationalisation and also served to ensure that the

\textsuperscript{11} See, Shwadran, op cit, ch.VI.
\textsuperscript{12} Yergin, op cit, pp 475-476.
Iranian government received half of the net profits attributed to its crude-oil production, the control of operations remained with the seven international oil majors who between them had a stake of 89 percent in the new consortium, with the ‘big three’ alone having a stake of 61 percent. In the words of Edith Penrose:

Although in one sense the Anglo-Iranian Oil Company lost its struggle with the Iranian Government, it can hardly be claimed that the Government won. To be sure the Government did ‘nationalise’ the local operations, although it is not accurate to say that it nationalised the oil which, like other sub-soil minerals, belonged to the Government in any case, and it did break the complete monopoly of AIOC when other companies were brought into the Consortium. But the Consortium that was set up after prolonged negotiations, great economic losses, and severe political damage, brought little improvement in the direct economic benefits derived by the Iranian economy from the operations of the foreign Companies that could not have been obtained by less drastic means. On the other hand the creation of a National Oil Company with a greater sense of participation in, and greater responsibilities for, the development of the country’s oil industry was a significant step.\(^\text{13}\)

Although the Iranian episode may not have had much of an impact as far as the distribution of rents between the oil companies and the Iranian state, it was not without substantial significance in terms of its long term impact on regime norms. As Daniel Yergin has observed:

\(^{13}\text{Penrose, op cit, p 67.}\)
The establishment of the consortium marked one of the great turning points for the oil industry. The concept of the concession owned by foreigners was for the first time replaced by negotiation and mutual agreement...in Iran, all parties acknowledged, again for the first time, that the oil assets belonged, in principle, to Iran. Under this new deal, Iran’s National Iranian Oil Company would own the country’s oil resources and facilities. But in practice, it could not tell the consortium what to do. The consortium would, as a contract agent, manage the Iranian industry and buy all the output, with each company in the consortium disposing of its share of the oil through its own independent marketing system.\(^\text{14}\)

Thus the seeds of competing regime norms, namely, that the oil producing states were the owner’s of their country’s oil resources which ultimately ought to be managed and operated through National Oil Companies were undoubtedly laid in the aftermath of the Iranian nationalisation episode. At the same time these events also sent a clear message to the oil producing countries that the regime established by the oil majors was far too strong to be dismantled at this juncture because without the co-operation of the international oil companies neither crude oil nor petroleum products could be sold in any significant quantities. As we have already pointed out in the previous chapter, much of the world’s processing and distributing facilities were in the hands of the ‘Seven Sisters’, who in the

\(^\text{14}\) Yergin, op cit. p.476.
Iranian episode refused to handle the expropriated oil, and others were deterred since AIOC threatened legal action against anyone who did so. Thus the Iranian episode drove the point home in no uncertain terms to the oil producing countries that they were umbilically linked to the international oil majors and as a consequence even during the tense aftermath of the Arab-Israeli war of 1967 none of the major oil exporting countries risked taking the path of nationalization of the assets of the oil majors.

**The Developments in Iraq**

With the adoption of the Fifty-Fifty system in Saudi Arabia, the financial arrangement under the Iraqi concession was also replaced by the Fifty-Fifty system in 1952 through an agreement between the government of Iraq and the Iraq Petroleum Company. At that date, the IPC held directly as well as through the intermediary of two subsidiaries, the totality of the rights to Iraq petroleum, extending over an area of more than 160,000 square miles, but had in fact developed only a small part of the area covered by the concession. The government of Iraq had been pressing for some time for modifications in the concession agreement with the Iraq Petroleum

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15 Shwadran, op cit, pp 246-247
Company but had kept this issue out of the public domain for fear of arousing popular passions which were already ranged high against the feudal Hashemite monarchy which ruled the country. The 1958 revolution abruptly brought to an end twenty-six years of Hashemite rule and among the first acts of the new regime was to confront the oil companies with demands for a modification of the existing concession agreement.17

The negotiations, which continued intermittently from the autumn of 1958 to their ultimate breakdown in October 1961, revolved around four main issues:

1. the relinquishment by the oil company of some of the territory held under its concession agreement with the government;
2. Profit sharing arrangements;
3. the rights to natural gas; and
4. equity participation by the government in the IPC.

The government refused to settle on any individual issue, insisting all along on a ‘package deal’ which would include a settlement of all the outstanding issues together. As Penrose has observed:

17 For a detailed account see Shwadran, op. cit., ch. XIII.
"It seems clear that part of Iraq's purpose in these negotiations was to break the existing pattern of profit-sharing and concession arrangements that had up til then prevailed in the Middle East." 18

The concession held by the IPC, which gave it exclusive rights to explore, produce, refine and export crude oil, covered virtually the entire territory of Iraq. The IPC expressed its willingness during the negotiations to relinquish over half the area provided they could choose the areas to be surrendered. This stand was further diluted during subsequent negotiations and although offers were made by IPC which would have been tantamount to surrendering eventually virtually 90 percent of the area under the concession, no agreement could be reached on account of the government's insistence in being involved in the selection of areas to be relinquished.

Under the Fifty-Fifty profit sharing arrangement, the government was entitled to 50 percent of the difference between the agreed cost of crude-oil production and the posted prices, which theoretically at least were under the control of the oil companies. In the fresh negotiations the Iraqi government wanted to reopen the earlier agreement and demanded a higher share of the difference without specifying the precise proportion. Even while the

18 Penrose, op cit, p70.
negotiations were going on, the oil companies twice reduced the posted prices of crude oil throughout the Middle East with far reaching consequences which we shall discuss in greater detail later.\textsuperscript{19} These reductions by reducing the calculated profit attributed to crude oil also \textit{ipso facto} reduced the government take from crude oil production. As Penrose has observed:

"The suspicion was widespread, though certainly unfounded as subsequent events confirmed, that the Companies had reduced posted prices for crude, not because of competition and lower prices in product markets, but in order to squeeze independents trying to enter crude oil production, and that therefore the existing pressure on prices would only be temporary."\textsuperscript{20}

A major issue of contention was the demand of the Iraqi government for equity participation in the IPC group. There was a provision dating back to the San Remo oil agreement of 1920 which established the British mandate over Iraq, that Iraqis would have a right to take up 20 percent of any new

\textsuperscript{19} The first reduction in February 1959, led to a resolution of the First Arab Oil Congress in April 1959 that the producing governments should be consulted about price changes: the second reduction in August 1960, led to the formation of the OPEC.

\textsuperscript{20} Penrose, op cit, p 71.
shares that might be issued by IPC. However, no such shares had ever been issued and this was an issue of dissatisfaction with the Iraq government. In addition to the principle involved, which the companies were unwilling to accept, not least because it was likely to open the floodgates for similar demands elsewhere, there was also the complicated issue of share valuation - the government wanted the shares at book value which the IPC considered wholly unrealistic.

In October 1961, the negotiations broke down completely and in December 1961 the Iraqi government promulgated Law No.80, which unilaterally expropriated around 99 percent of the concession area of the IPC group. The consequence of this law was that it effectively put an end to any further expansion by IPC in Iraq but stopped short of an outright nationalization of its operating facilities. However, a united posture by the international oil companies stymied the efforts of the Iraq Government to take over the full management of the concession. The IPC, which managed the concession, responded by cutting back on production by nearly 30%.21 The oil majors (Shell, British Petroleum, Mobil and standard of New Jersey) which controlled IPC did not suffer on account of this as production was

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stepped up in other oil producing states. Iraq offered the confiscated areas to other oil companies for immediate exploitation. No bids were forthcoming and these areas remained unexploited for the following seven years.\textsuperscript{22} Investments originally intended for Iraq were diverted to the development of other fields in the Persian Gulf, which were to generate additional competition for Iraqi oil.\textsuperscript{23} The sustained posture of solidarity presented by the international oil majors prevented any other threat to the established international oil regime. After the Arab-Israeli war of 1967, the Iraqi government gave up any further attempts to negotiate with the IPC and passed a further law reserving all the unexploited areas of Iraq for exploitation by the state owned Iraq National Oil Company, which was also empowered to enter into arrangements with foreign companies for this purpose.

Commenting on the significance of the developments in Iraq on the emerging petroleum order Penrose has observed:

The Iraqi negotiations were doomed to failure, not only because the Government was striking at the very heart of the arrangements governing the established operations of the major Companies, but also because Iraq was acting alone in so doing. Nevertheless, within the next few years provision for the

\textsuperscript{22} Hartshorn, J.E. \textit{Oil Companies and Governments: An Account of the International Oil Industry and its Political Environment} (Faber and Faber 1962), p.329

\textsuperscript{23} ibid
automatic relinquishment of concession areas, an increased share of oil receipts for the governments of producing countries and provision for equity participation by the government, were to become almost standard in new concession agreements and, with the exception of the last, even incorporated in modifications of the existing agreements. 24

**Acceleration Towards Regime Transformation**

The significant changes that had made their appearance on the fringes of the international petroleum order in the 1950s substantially accelerated by the close of the decade on account of four mutually reinforcing factors:

(a) the increased competition for new concessions to explore for and produce crude oil, including the entry of new oil firms often referred to as ‘independents’;
(b) increased competition in the crude oil and product markets which directly and indirectly affected prices and brought changes in the policies of some importing countries;
(c) the increasing importance of government policies and state intervention in the petroleum industry; and
(d) the growing solidarity among the oil producing countries and the formation of OPEC.

We shall discuss each of these developments in the paragraphs to follow.

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24 Penrose (1968) op cit, p 72.
The Competition for New Concessions and the Entry of Independents

In the decade following the end of World War II, most of the production, processing and the distribution of the world's petroleum was in effect controlled by eight international oil companies. In the United States there were a large number of oil companies that produced significant quantities of crude oil in North and South America but had not yet extended their presence to other parts of the world on any significant level. These companies are usually referred to as 'Independents' to distinguish them from the oil majors. In comparison with the oil majors their operations were on a much smaller scale and were usually, at least initially, confined to one stage of the petroleum process, namely exploration and production of crude oil.25

Prior to the formation of the Iranian Consortium in 1954, there were very few independents operating in the Middle East. However, due to pressure from the US government (which in turn was under pressure from these companies, domestically), nine independent American oil companies obtained a combined share of five percent in the Consortium through the

25 For a detailed description of the main 'independent' oil companies see, Penrose, op cit, p 133-144.
This development gave substantial impetus to the activities of the independents in the Middle East. In the second half of the 1950s a large number of independent oil companies with virtually no international operations or experience began seeking concessions to explore and produce crude oil in various parts of the world, including the existing oil producing areas.

When Venezuela in 1956-57 put to auction large tracts of virgin territory for oil exploration, a large number of American independents were attracted and also paid substantial amounts to win the concessions. In Libya during the four year period 1955-59, concessions covering 55 percent of the land area of the country were granted to fifteen oil companies or groups, including six of the seven majors, CPF and American and German independents. In 1964 when Iran placed on offer some offshore areas for competitive bidding, around thirty companies, of which 26 were

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26 Yergin, op cit, p 477-478.
independents, came forward most of them combining in groups for the purpose. The five groups that succeeded in winning concessions consisted of 20 independent companies and only one major. 28

Competition between the international majors and the independents for the new concessions brought about significant changes in the prevailing pattern of concession terms. In the beginning, the American independents, ENI (the Italian state oil company) and the Japanese companies were the main innovators in this regard. In 1957 the National Iranian Oil Company (NIOC) was authorised by the government of Iran to undertake exploration activities and to take foreign companies as partners for this purpose. As a result, concession agreements were signed by NIOC with AGIP (a subsidiary of ENI) and Pan American Oil Company which for the first time went beyond the fifty-fifty division of profits principle, provided for automatic relinquishment of the area under concession with the passage of time, placed the exploration risk entirely on the concessionaire, and also provided for equity participation by the NIOC. 29

Around the same time Arabian Oil, a Japanese company, obtained offshore concessions from Kuwait and Saudi Arabia which fixed the

28 Penrose, op cit, p 74.
government take at 57 percent and 56 percent of the profits respectively, provided for a 10 percent share in the enterprise in the event of an oil discovery, and also contained provisions for automatic relinquishment of a part of the concession area. By 1961, even one of the oil majors had entered into an agreement for an offshore concession which gave the host government the right to buy a 20 percent share in the producing enterprise in case oil was discovered in commercially viable quantities. Other far reaching innovations involved French companies and included the formation of a joint company with the Saudi Arabian state oil company in 1965 with the latter having a 40 percent stake, agreement with National Iranian Oil company (NIOC) in 1966 which, among other things, provided for handing over half the discovered reserves to NIOC for development and loans for this purpose in addition to marketing of NIOC’s oil if desired. In the latter arrangement the company was performing more the role of a contractor to NIOC than a concessionaire.

Let us now briefly summarise the impact of the entry of independents on the prevalent international oil regime. In the first instance, as we have seen,

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29 Shwardan, op cit, pp 164-167.
31 Shwadran, op cit, pp 167-168. See also Penrose, op cit, p 75.
the competition from independents had a major impact on the pattern of concession terms, particularly on the distribution of benefits, which without doubt were 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 the concessions had the effect of substantially raising the rents accruing to the host governments and also strengthened the long held suspicion that they had been exploited by the majors in the past. Second, the entry of independents was to a large extent responsible for the expansion of world supply, which led to erosion of prices. The share of independents in world crude oil production rose from around 4 percent in 1952 to nearly 18 percent in 1965.\textsuperscript{32} When the international majors attempted to curtail production to preserve the price structure, they met with resistance from the host governments, as such a step would erode the revenues accruing to the latter. Another significant implication of the entry of independents was their ability to develop downstream outlets for foreign crude oil, thereby loosening yet another part of the major’s control of the market.\textsuperscript{33}

\textsuperscript{32} Rouhani, op cit, p 51.
\textsuperscript{33} Ahrari, op cit, p 17.
Increased Competition in the Crude and Product Markets

The increased competition for new concessions, the entry of fresh players in the field of exploration and the successful search for new reserves of oil brought into the market added supplies of crude oil, some of which was controlled by the established oil majors, but mainly by the newcomer independents and partly by the newly created state oil companies. Most of these 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. Thus between 1950 and 1966, the percentage of world refinery throughput handled by the seven international oil majors fell from 72 to 61, the balance being processed by new, usually unintegrated refining companies.\(^{34}\)

In effect, the competition for new sources of crude oil, for refining capacity to process the added crude and for product markets spawned new patterns of organisation of the production, processing, and distribution of petroleum products. In the process, one of the significant norms of the prevalent oil regime, namely vertical integration was seriously eroded.\(^{35}\)

\(^{34}\) Penrose, op cit, p 78.
\(^{35}\) Mikdashi (1972) op cit, pp 45-50.
Apart from the factor of competition mentioned above, the cost advantages of integration were greatly diminished by the increasing taxation of profits attributed to crude oil production. Till the mid-1950s, the inter-affiliate transfer price of crude oil was taken to be the price of crude oil for tax purposes. By the early 1960s, because of efforts by the oil producing states to garner as much of the economic rent as possible, the ‘tax price’ of crude oil was pegged substantially higher. In addition, the increasing involvement of the host countries in the managerial decisions relating to the production of crude oil, reduced both the attraction and the advantages to an oil company of having its own crude oil supply. This factor was accentuated by the falling trend of crude oil prices throughout most of the 1960s.

*Increasing Importance of Government Policies and State Intervention*

In the late 1950s and throughout the 1960s government policies became of increasing significance to the international petroleum order. The two countries that were both major producers as well as consumers were the US and the USSR and their foreign trade policies relating to oil were important factors affecting the international oil market. Between 1958 and 1960 crude oil exports from the USSR doubled adding to the pressure of supplies in the
world market. By 1965, along with Eastern Europe, she accounted for 6 percent of world exports.\(^{36}\) In contrast, the US became a net importer of crude and products after the Second World War and during the 1950s rising imports raised the spectre of a danger to the country’s economic and military security arising out of excessive import dependence. This coupled with the political pressure exerted by domestic oil and coal producers against imports of cheap foreign oil, led to the imposition of voluntary and then mandatory import quotas for crude oil in 1958 which hit hard the US companies that had acquired the ownership of large reserves of crude oil in many parts of the world.\(^{37}\) It also reduced substantially the extent to which the US market could absorb greater quantities of the rising supply of crude oil outside the US

The main importing countries, with little or no local production, adopted different strategies for meeting their requirements of oil security, depending on the specific circumstances that they were confronted with. As we have already seen, Britain sought security of supply through the ownership of oil reserves by British companies in the territories within the British sphere of

\(^{36}\) Penrose, op cit, p. 80.

\(^{37}\) Yergin, op cit, pp. 535-537.
influence. Thus the British took a controlling interest in British Petroleum as early as 1914.

It was, however, the advent of the newcomers, the French, the Japanese and the Italian national (though not necessarily state owned) oil companies that had important consequences for the established regime. The French had acquired a stake, albeit a small one, in the IPC before the war and in the Iranian Consortium in the 1950s. However, the largest French reserves were in Algeria and as Algerian oil began to flow, the French government made it mandatory for refiners in France to take a specified quota of this oil. The Japanese acquisition of crude oil reserves overseas was primarily a private venture, but the government did assist in finding outlets for this crude by requiring refiners in Japan to take a stipulated percentage of their supplies from the Japanese company. The primary objective of the ENI, the Italian State Oil company was to secure oil reserves for the country and the ENI took the lead in entering into partnership agreements with other governments both in the area of production as well as refining by openly advocating a preference for government to government contracts, in lieu of the arrangements made with the private international oil companies. The French and the Japanese oil companies (particularly the former), as we have seen
earlier, entered into innovative arrangements with the oil producing countries which were very far removed from the pattern of the early concessions that were obtained by the majors. As Rouahni has observed in this context:

The major companies have a cause of anxiety more serious than the possible increase of USSR exports. Their influence, which is still considerable owing to their enormous investments in all phases of the industry, declines nevertheless as the traditional structure of the industry changes - on the one hand, with the growing activities of other private companies, integrated or not, that are competing with them, and on the other, with the new policy of producing countries in favour of exploitation agreements in which the co-contractors are government oil agencies of industrialised consuming countries.\textsuperscript{38} (Emphasis added).

It was, however, in the oil producing countries that governments were increasingly asserting their rights for a greater degree of participation in the conduct of the oil industry located within their national territories. Some countries were insisting on substantial state participation in producing operations while others on an extensive supervisory and regulatory system. Significantly, by the late 1960s, in almost all the major oil producing countries, state owned National Oil Companies had been created.\textsuperscript{39}

\textsuperscript{38} Rouhani, op cit, p 58.
\textsuperscript{39} Penrose, op cit, pp 82-83.
Organisation of Petroleum Exporting Countries (OPEC)

OPEC was established at a conference held in Baghdad in September 1960 of five major petroleum exporting countries, namely Iran, Iraq, Kuwait, Venezuela and Saudi Arabia. Although the proximate cause was an outraged sense of injustice on the part of the oil producers at what were perceived to be unilateral and unjustified cuts in the posted price of oil by the oil majors (about 8 percent in February 1959 and around 6 percent in August 1960), much of the ground had been laid through the initiatives of Venezuela earlier. Venezuela, as the producer with the highest average costs of production among the major oil exporters, had the highest stake in prevention of competition which would depress prices. For the pressure on prices to be eased, Venezuela believed that a stronger control on the rate of production would need to be maintained and towards this end active co-operation among the major producers was essential since individual efforts would be doomed to failure. Venezuela had therefore taken the lead in promoting active contacts and mutual consultations among the oil exporting countries to make them increasingly aware of their mutual interests and imperative need for co-operation to deal with the awesome organisational power of the multinational oil companies.\(^\text{40}\)

\(^{40}\) See Mikdashi (1972) op cit, pp 22-34.
Thus OPEC came into existence as an economic alliance with Iran, Iraq, Kuwait, Saudi Arabia and Venezuela as its founding members. Qatar joined in 1961; Indonesia and Libya in 1962; Abu Dhabi in 1967 (subsequently replaced by the United Arab Emirates [UAE] of which Abu Dhabi is a dominant member); Algeria in 1969; Nigeria in 1971; and Ecuador in 1973. Gabon was admitted as an associate member in 1973.

The aims of the organisation were determined unanimously in the first conference and were articulated in the first two Resolutions. Rouhani\textsuperscript{41} has summarised these as follows:

(1) Endeavouring by all possible means to restore the price of crude oil to the level existing before the reductions.

(2) Ensuring that oil companies maintain their prices at a stable level, avoiding unnecessary fluctuation.

(3) Demanding that the companies should consult the countries concerned each time they consider that the position of the market calls for a modification of prices. In such event, they would have to furnish full explanation to justify their point of view.

\textsuperscript{41} Rouhani, \textit{op cit}, p 79.
(4) Elaborating a formula to ensure the stability of prices, and for this purpose resorting, if necessary, to a regime of control of production. (Emphasis added)

(5) Conducting the Organisation’s studies and activities in conformity with the following objectives: guaranteeing a stable revenue to the producing countries, an effective and regular supply of petroleum to consumers, and an equitable remuneration to investors.

(6) Organizing a system of regular consultation among the members with a view to co-ordinating and unifying their petroleum policies, and determining the best means of safeguarding their common interests both individually and collectively.

The statutes of OPEC provided for three categories of membership: founder, new and associate. Founder members were the five countries that were present in the Baghdad conference September 1960 and had brought the organisation into being. New membership was open to any country with substantial net exports of petroleum but admittance required the unanimous consent of the founding members. Further, in order to become a full
member, a petroleum exporting country must have fundamentally similar interests to those of member countries.  

In terms of the objectives for which it was established, the two main tasks that the fledgling organisation had to undertake were (a) stabilisation of oil prices, and (b) production programming or prorationing which involved assigning production quotas to the participating members of the organisation. Both these goals were intimately linked to each other since without establishing control over supply, price stabilisation would obviously prove elusive. However the whole issue of prorationing floundered on the precise criterion to be employed for fixing production targets among the members. Given the revenue needs of the participating countries this proved to be an extremely complex and difficult task. As Shwadran has observed:

If prorationing of production should be adopted in order to maintain high prices for crude, exploration and extension of exploration or reserves would practically come to standstill in the prorated countries and, conversely, would expand in the non-prorated countries, even though the lands of OPEC members contained a very high percentage of the world’s reserves.  

Throughout the decade of the 1960s, the weakness of the oil market resulting from plentiful supply of crude oil combined with the intrinsic

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42 For a detailed account of the institutional aspects of OPEC, see Mikdashi, op cit, ch 4.
strength of the prevalent international oil regime, prevented the oil producing countries from developing any concrete consensual plans of action which could threaten the existence of this regime. From the viewpoint of raising crude oil prices, potentially, the most potent instrument was prorationing. However its actual operationalisation was fraught with immense difficulties as it conflicted with the primary concern of the oil producing countries of maximising oil revenues which was possible only by expanding production. Prorationing at this juncture was in consonance only with the policy objectives of Venezuela, which was expectedly its most passionate advocate, as it possessed the most developed oil industry among all the OPEC members and its high cost oil was in no position to compete with the large low cost supplies flowing out of the Middle East.

On the ineffectiveness of OPEC during its early years, Ahrari has commented:

The pendulum of power was clearly swinging in favour of the multinational oil corporations. Throughout 1960-1967, the companies were riding the uncertain tide of the buyer’s market, and OPEC remained a weak and ineffective institution. The challenges faced by the fledgling organisation...were enormously complicated and were frequently in conflict with the economic interests of a number of member states. Almost all members save Venezuela lacked the kind of technical

43 Shwadran (1973), p 506.
expertise required for dealing with the international majors, who not only excelled in every aspect of the oil business but also, despite a flurry of activity by the independents, retained firm control over the international oil market.44 (Emphasis added)

In terms of immediate impact on the established oil regime, it would not be far wrong to say that the establishment of OPEC achieved very modest results both from an economic or distributive point of view. However, it did raise the level of awareness on oil issues among its members and increased the bargaining power of the oil producing countries. Credit is often given to OPEC for the fact that after its formation posted prices were not reduced even as ‘market’ prices continued to slide during the 1960s.45

Conclusions

Let us now summarise the main conclusions emerging from the discussions in this chapter. It may be recalled that the First Oil Regime was founded on three dominant norms, namely, contractual arrangements known as concessions between the oil producing countries and the international oil companies for the exploration and exploitation of oil; the management of the international petroleum system through an oligopolistic arrangement among

44 Ahrari, op cit, p 30.
45 Penrose, op cit, p 83.
the international oil majors; and a vertically integrated organisation as being best suited for the efficient conduct of the international oil business. To this may be added another norm of perhaps lesser significance: direct state intervention in the conduct of the business of oil was neither necessary nor desirable and it was best that this activity was left in the hands of private actors.

As we seen in the course of this chapter, many of these norms had begun to be challenged as early as in the 1950s but without serious impact on the prevalent oil regime. The concession arrangements underwent modifications which increased somewhat the share of rents accruing to the oil producing countries without questioning the legitimacy of the arrangements themselves. The entry of independents brought in new forms of organisation, a movement away from vertical integration, while at the same time improving concession terms for the oil producers due to the increased competition. The creation of state owned National Oil Companies in many of the important oil producing countries was a new concept altogether. It was an assertion, symbolically at first, of the intrinsic right of the oil producing countries to manage their own resources. All these developments
did loosen, albeit not significantly, the oligopolistic control of the major international oil companies.

These trends accelerated in the 1960s. The pattern of concessions underwent further modifications, mostly at the initiative of the independents and especially of the oil companies of some of the developed importing countries such as Italy and France. As a consequence the distribution of rents accruing to the oil producers significantly increased. The proportion of oil business handled by unintegrated oil companies also went up substantially. The creation of OPEC was a significant development, not in terms of its immediate impact on the oil regime but in the coming into existence of potential countervailing power with objectives and norms that conflicted with those of the prevalent regime. The creation of an organisation with well defined organs and clearly laid down procedures, whose members together in 1968 accounted for 69 percent of the total petroleum reserves of the world, had laid the foundation for the creation of an alternative petroleum order, if perchance the old 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 and its

\[46\text{Rouhani, op cit, p. 103}\]
acceleration through the decade of the 1960s. As we have mentioned in the opening chapter, according to the structural realists, regimes essentially have no independent existence of their own and are merely projections of the underlying structure of power relations. According to this view, therefore, 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 the 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. Most, if not all, 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 itself which squares up well with the Grotian conception, which regards regimes as pervasive phenomena of the international system and not mere adjuncts of power relationships and configuration of interests. We can conclude that the first oil regime came to function as an independent variable with tangible consequences on the international system that were, in most part, not directly linked to changes in the underlying structure of power relationships or in the configuration of interests.
CHAPTER FOUR: REGIME COLLAPSE (1970-1973)

Although the establishment of OPEC was a significant milestone in the creation of an alternative oil regime, it was in the first decade of its existence quite powerless to bring about the collapse of the existing petroleum order. However, even in the beginning, by actively intervening in the determination of posted prices "and pledging that they should not be reduced, [it] added an important new structural element to the international oil industry."\(^1\) The seeds of the new order had been planted.

The First Oil Regime was, as we seen in the preceding chapter, a regime in decline throughout the 1960s. During the period 1970-1973 the regime collapsed on account of certain significant economic and political developments, which we proceed to discuss next.

**Change in Market Conditions**

Beginning in the late 1960s and continuing through the early 1970s, the international oil market was transformed from a buyer's to a sellers' market on account of a variety of factors.\(^2\) On the demand side, the world consumption of total energy (which includes coal, oil and natural gas, and

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\(^1\) Moran (1987), op cit, p 597.
\(^2\) For a detailed account, see Ahrari, op cit, ch. 3.
primary electricity) increased rapidly between 1950 and 1970. Expressed in terms of units of 10 to the power of 15 BTUs, world consumption increased from 76.8 in 1950 to 124 in 1960 to 214.5 in 1970. This rising trend in energy use was accompanied by a significant change in the pattern of energy consumption as will be evident from the table given below:

**TABLE 4: Source of World Energy Consumption: 1950-1972 (percent)**

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<thead>
<tr>
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<tbody>
<tr>
<td>Coal</td>
<td>55.7</td>
<td>44.2</td>
<td>31.2</td>
<td>28.7</td>
</tr>
<tr>
<td>Oil</td>
<td>28.9</td>
<td>35.8</td>
<td>44.5</td>
<td>46.0</td>
</tr>
<tr>
<td>Nat. Gas</td>
<td>8.9</td>
<td>13.5</td>
<td>17.8</td>
<td>18.4</td>
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<tr>
<td>Electricity</td>
<td>6.5</td>
<td>6.4</td>
<td>6.5</td>
<td>6.9</td>
</tr>
</tbody>
</table>


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. In a situation of rising...
world energy consumption, coal was increasingly being substituted by oil and this translated into a sharp rise in the international demand for oil.

At the same time, for a variety of reasons, the supply of oil in the international market was becoming inelastic, implying thereby that price increases were not resulting in greater availability of crude. This was not related to declining rates of production since most of the Middle East oil producers maintained sustained increases in the absolute rates of production to meet their revenue needs. The inelasticity was linked essentially to a sharp decline in world spare capacity in crude oil production (i.e. the idle capacity for producing crude oil that was available for increasing production to meet sudden increases in demand or to compensate for unexpected disruptions in supply) between the late 1960s and early 1970s. This was mainly related to the decline in spare capacity in the United States where until the early 1960s, most of the demand for oil was met by domestic production.\(^4\) Within the next ten years, however, the US was importing one third of its oil requirements and spare capacity was down to 10 percent compared to level

of 25 percent in the 1960s.\(^5\) As will be apparent from the figure below, the world spare capacity which had hovered around a level of 6 million barrels per day in the early 1960s declined sharply between the late 1960s and early 1970s.\(^6\)

**World Crude Oil Spare Capacity and Demand, 1955-1975**
*(Excluding Communist Countries)*


\(^5\) Moran, op.cit.p 597.footnote 52
\(^6\) Multinational Corporations and United States Foreign Policy (US Congress 1974) p 212
The Middle East was the main supplier for the rapidly growing demand for oil in the developed consuming countries of Western Europe and Japan, and was increasingly becoming so for the United States as well. In 1968, Western Europe consumed around 50 percent of total oil exports from the Middle East of approximately 10.5 million barrels a day and Japan around 25 percent. This dependence on Middle Eastern oil was projected to rise sharply in the coming years.

**The Suez Crisis**

The Suez Canal had served as a vital economic link between the oil producing countries of the Middle East and the oil consuming countries of Western Europe for over a century. The closure of this canal in the aftermath of the 1967 Arab-Israeli war had far reaching consequences for the international oil trade. The shorter route between the Persian Gulf and Western Europe was severed forcing oil supplies from the Middle East to take the circuitous route round the Cape of Good Hope to reach their Western European destinations. This had its concomitant impact on tanker rates and freight costs, which increased throughout the world.

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7 Ahrari, op cit p 37.
8 For a detailed account of the 'Suez Crisis', see Yergin, op cit, ch 24, pp 479-498. See also, Skeel, Ian, *OPEC- Twenty Five Years of Prices and Politics* (Cambridge University Press, 1988) pp 44-46.
The Suez closure had radically different impacts on the oil producing countries of the Persian Gulf and the Mediterranean. Of the Mediterranean states (Libya, Algeria, Saudi Arabia and Iraq), Libya and Algeria had locational advantages because of their proximity to Western Europe. The oil producing states of the Persian Gulf were now locationally disadvantaged by having to send their oil supplies around the Cape of Good Hope to Western Europe. Even Saudi Arabia and Iraq, which had limited access to the Mediterranean through the Trans-Arabian Pipeline (known as Tapline), had no alternative but to ship the bulk of their oil around the Cape. As the Persian Gulf oil was obviously costlier as a result of higher freight, this provided an opportunity to the Mediterranean producing countries to demand higher oil prices on the basis of locational advantage.⁹

**Developments in Libya**

The first major blow to the established regime came from developments in Libya where a revolutionary government took over in a bloodless coup in September 1969. Oil was very high on the new government’s agenda and it

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almost immediately, in January 1970, initiated negotiations with the oil companies for raising the posted prices of crude oil produced in Libya. At the same time in order to put pressure on the oil companies and make absolutely clear that it meant business, it announced co-operative agreements with Algeria and other Arab oil states and initiated oil related technical co-operation with the Soviet Union and countries of the socialist bloc. Substantively, these contacts aimed at utilising the technological know-how of these countries for developing indigenous expertise in the upstream oil industry and towards this end in March 1970, the government established the Libyan National Oil Corporation (Linoco) as a National Oil Company with the mandate to develop upstream and downstream activities, including joint ventures.

Libya had a number of independent oil companies and several international oil majors operating within its territories. While the Libyan government was aware that it may prove difficult to apply pressure on the majors, it knew that the independents were more vulnerable because of their substantive dependence on Libyan oil. As a strategy, the Libyan government decided to curtail the production of its concessionaires, especially that of the

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10 See Yergin, op cit, pp 577-580.
independents. In addition to these cutbacks in production, the Libyan government declined to negotiate with the oil companies as a block, adopting instead a strategy of separate negotiations.11

In adopting such a strategy, Libya was fully cognisant of its strong bargaining position. In 1969, Libya supplied over a quarter of the oil consumed by Western Europe where its low-sulphur oil was in high demand. Along with this growing dependence on Libyan crude, the production of coal, the main alternative source of energy was declining rapidly in Western Europe, thereby putting pressure on the oil companies to increase levels of supply. In May 1970, the Tapline in Syria was broken by a bulldozer and the regular flow of half a million barrels of crude oil per day from Saudi Arabia was stopped. Repairs on the pipeline were delayed. To obtain Saudi oil, more tankers had to be employed which led to sharp rise in freight rates, thereby increasing the locational advantage of the Libyan oil fields as they were closer to the consuming destinations.12 The loss of Saudi Arabian oil on account of the closure of the Tapline combined with the implementation

11 For a detailed account, see Mosely, Leonard, Power Play: Oil in the Middle East (Random House, 1973), ch 24, pp.320-33
of the new conservation policies resulting in reduced production of Libyan crude, led to a sharp tightening of the supply position in the international oil market.\textsuperscript{13}

As a tactical measure, it was ultimately the independents who were substantially dependent on Libyan oil who were singled out for strong-arm treatment by the government. In September 1970, Libya nationalised the oil concessions of the Occidental Petroleum Company, an independent whose only source of income was Libyan oil. Occidental accepted a compromise that had the effect of raising the posted price of crude by $0.30 and increased taxes to 58 percent of the profits from the earlier 50 percent.\textsuperscript{14} This came to be referred to as the Tripoli I Agreement. Eventually, the other independent oil companies in Libya accepted the same terms. Confronted with the prospect of losing the entire Libyan concession, all the major international oil companies also acceded to these terms. It was apparent that the developments in Libya had significantly altered the oil company-country relationship.\textsuperscript{15}

\textsuperscript{13} Ahrari, op cit, p 35.
\textsuperscript{14} Choucri (1976), op cit, p 33.
\textsuperscript{15} For a detailed account, see Terzian, op cit, pp 118-122.
Although the Tripoli I agreement was concluded outside the framework of OPEC, the organisation was highly supportive of the Libyan endeavours and this was crucial in bolstering its bargaining position vis-à-vis the oil companies. On the significance of the Tripoli I, an Arab oil analyst has commented:

The precedent-shattering hikes in prices and tax rates were fascinating not only because of their magnitude but also and primarily because of their political significance since they demonstrated that the major oil companies were no longer invulnerable and that they no longer formed a power centre independent of the governments of the countries in which they operate.... In fact, the thunder of the Libyan settlement started its ball-rolling effect throughout the oil-producing countries... 16

Also, Choucri has observed: “The Libyan experience signalled the emergence of exporting governments as prime determinants of the petroleum market.” 17

The Tehran Agreement

The success of Tripoli I had opened up a virtual Pandora’s box and was to lay the ground for further company-country agreements. In the wake of Tripoli I, OPEC in its twenty first conference held in Caracas had expressed

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17 Choucri, op cit p.34.
its resolve to initiate a unified pricing strategy based on a regional co-operative approach. The basic principle involved was to treat separately the price problems of each region within OPEC jurisdiction. The negotiated increases in posted prices in one region were to serve as the basis for incorporating these increases in other regions.\textsuperscript{18} Three regional committees were set up for this purpose: the Gulf states committee comprising Iran, Iraq and Saudi Arabia; the Mediterranean committee comprising Libya, Algeria, Iraq and Saudi Arabia; and a third committee comprising Venezuela and Indonesia.

The Gulf States committee negotiated the Tehran Agreement, which was signed in February 1971. The Agreement included an increase in the posted price by $0.35 per barrel. Additional increases in response to inflation and to the rising demand for oil were also established. There was a stabilisation of tax rates at a level 55 percent and importantly for the companies, a willingness on the part of the oil states not to seek any further increases in

\textsuperscript{18} Terzian, op cit, pp 123-124. See also Skeet, op cit. pp 63-64.
terms of settlement for a period of five years.\textsuperscript{19}

The Tehran agreement was regarded as an unqualified triumph for OPEC with huge financial implications for the five affected members, namely Saudi Arabia, Iran, Iraq, Kuwait, Abu Dhabi and Qatar whose oil revenues were expected to at least triple as a consequence.\textsuperscript{20}

\textit{The Tripoli II Agreement}

Even before the start of the Tehran negotiations, the Libyan government had expressed dissatisfaction with the outcome of the Tripoli I agreement. The justification put forward by Libya for a further increase in the prices of crude was very similar to the one used in justification of Tripoli I, namely, that Libya should get more than the 55 percent profit sharing already agreed to by the companies on account of its locational advantage stemming from the continued closure of the Suez Canal.

The Libyan rejection of Tripoli I which was required to be in operation for a five-year period set a precedent of substantial significance in oil transactions. However given the enormous dependence of the industrial consuming countries on OPEC oil and the sustained weakening of the

\textsuperscript{19} ibid, pp 138-139. See also Skeet, op cit, pp67-68.
\textsuperscript{20} Middle East Economic Survey, Feb. 19, 1971.
international oil companies vis-à-vis the oil producing states, enabled the oil producers to simply ride roughshod over the principle of sanctity of contracts whenever it so suited them to do.

The Libyan bargaining position received a substantial boost in February 1971 when Algeria nationalised 51 percent of all oil production and 100 percent of all gas production that still remained with French oil companies in Algeria.21 With the threat of nationalisation and production cutbacks hanging over their head, a five year agreement was concluded in March 1971 between the Libyan government and the oil companies which included among other things, the posted prices being increased by $0.35/b in line with the Tehran agreement plus $0.07/b as a fixed freight premium; $.010/b as premium for low sulphur and two temporary freight premiums. The posted price of Libyan crude as a consequence rose from $2.55/b to $3.45/b. the tax rate was also raised from 50 to 55 percent.22

With the conclusion of the first Tripoli agreement of September 1970, the Tehran agreement of February 1971 and the second Tripoli agreement of

21 Skeet, op cit, p 69.
March 1971, the pendulum of oil power had decisively swung in favor of the oil producing states and OPEC was recognised by the multinational oil corporations as a legitimate representative of the oil producing countries. The determination of posted prices, a function which was earlier performed almost exclusively by the international oil companies, was now being done by the oil producers, albeit through a process of negotiation with the companies. The old oil regime had very manifestly reached a state of terminal decline.

*The Geneva I Agreement*

One of the primary concerns of the oil exporting states was the issue of international inflation which was eroding the purchasing power of oil exports by adversely affecting the terms of trade between their economies and those of the Western industrialised countries. The Tehran agreement had incorporated an escalation clause in the posted prices of crude oil, which pegged the increase at 2.5 percent per annum for the period 1971-1975 as a protection against international inflation. However, OPEC members soon realised that the escalation provision had been set far too low.

Matters came to head with the US government announcing a suspension of the convertibility of the dollar into gold on 15 August 1971. The dollar
was now on a free float and its value expected to fall. The decision sent
tremors among the oil exporters since most them had their tax and revenue
payments tied firmly to the dollar and also held considerable amounts in
dollar holdings. The devaluation of the dollar also posed a major dilemma
for the oil companies, which had recently concluded three major agreements
and were looking forward to a period of price stability over the next five
years.

After a series of negotiations, which were marked by an extraordinary
degree of cohesion on both sides, an agreement between the oil industry and
the oil exporting countries of the Gulf and the Mediterranean regions, except
Libya, was reached on January 20, 1972 which, inter alia, provided for an
increase in the posted prices of the Persian Gulf states by 8.49 percent to
compensate for the fall in the value of the dollar. There was also a provision
for future price adjustments in response to alterations in the monetary
exchange rates. The agreement further guaranteed that the posted prices
would not be allowed to fall below than what had been agreed to in the

23 Skeet, op cit, p.71.
Tehran agreement. 24

The Geneva II Agreement

The Geneva I agreement which resulted in a gain of around US $700 million to the members of the OPEC failed, however, to satisfy the oil exporting countries that they were receiving a fair share of the profits from the sale of their crude oil in the Western industrial countries. In the meantime, the US government announced a second devaluation of the dollar by 10 percent in February 1973 as a consequence of which the oil exporting countries raised demands for renegotiating the Geneva I agreement as the automatic adjustment mechanism incorporated therein was perceived to be inadequate to protect their revenues. After a series of intra-OPEC consultations, 25 the OPEC negotiating team met with its counterpart from the oil industry in Geneva on May 28, 1973 and an agreement was reached on June 1 which came to be known as the Geneva II agreement. It had the following salient features: 26

(a) It preserved the framework of Geneva I, which provided some satisfaction to the oil industry.

24 Ghanem, op cit, pp 128-132. See also Skeet, op cit, pp 72-73.
25 For a detailed account of these consultation see Skeet, op cit, pp 75-82.
26 Middle East Economic Digest, June 8, 1973, pp 643-644. See also Terzian, op cit, p 149.
(b) OPEC contention that the escalation of 5.8 percent provided in Geneva I to compensate for the dollar devaluation was inadequate was accepted and higher escalations were agreed to. The basket of reference currencies for the purpose of determining the fluctuations was also expanded.

(a) Prices were to be reviewed on the 23rd of each month instead of quarterly as provided in Geneva I and would not be allowed to fall below the minimum level agreed to in the Tehran agreement.

The Geneva II formula was expected to remain in effect till 1975, when the Tehran and Tripoli agreements were to expire. However in the radically changed environment in the wake of the oil embargo of October 1973 and the unilateral price increases effected by OPEC, the Geneva II was quietly buried.

Geneva I and II considerably broadened the scope of the concerns articulated by the oil exporting states regarding the distribution of benefits under the existing oil regime. The agreements were also in some ways a portent of the radical transformation that was to soon follow, for having got involved in seeking long term solutions to problems that impinged on their welfare, the oil producing states were hardly likely to remain content with
merely negotiating periodic price increases. They would attempt instead to establish an altogether different petroleum order.

**The Participation Agreements**

Among the most significant achievements of OPEC in the early 1970s was the successful conclusion of the participation agreements which effected a qualitative change in the historical relationship between the oil producing states and the oil industry. These agreements thus whittled away at yet another pillar of the old regime and laid the foundation of the new order that was to shortly emerge. Although OPEC had spelt out its formal position on the subject in the ‘Declaratory Statement of Petroleum Policy in Member Countries’ in June 1968, there was little progress on the ground till the Extraordinary Meeting of OPEC in Beirut on September 22, 1971 in which the oil states officially unveiled the blueprint of their demands on participation.\(^{27}\)

On the specifics of participation, a majority of the oil states were seeking working interests in the concessions. An acceptance of this arrangement by the oil industry would have enabled the oil states to operate the concessions as their partners. The new demands of the oil states constituted a radical

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\(^{27}\) Terzian, op cit, pp 150-151.
departure from their original demand of acquiring equity shares in the concessionaire companies themselves.

The blueprint also contained two crucial and contentious issues, on the satisfactory resolution of which rested the fate of the participation agreements. The first was the issue of compensation regarding which the oil states were united in the view that this should be based on net book value of investment. The second troublesome issue concerned the modalities of marketing and pricing the share of the host governments’ crude oil. To minimise the possibility of destabilisation of crude prices in the international market, OPEC not only wanted close co-operation between oil companies and their foreign concessionaires but also insisted that, at least initially, the bulk of the oil states’ share of the crude oil move through the integrated channels of the international oil companies.\(^\text{28}\)

As far as the oil industry was concerned, these demands were simply unacceptable, as they constituted an attack on the very core of the regime that had been so assiduously created by them. They, therefore, decided to put up a united front. However, certain events took place, which had the effect

\(^{28}\) For a fairly comprehensive account on the intra-OPEC debates on participation, see Terzian, op cit, ch 7, pp 147-162. See also Skeet, op cit, pp 71-73.
of boosting the bargaining position of the producer countries while at the same time creating a climate of uncertainty and thereby seriously undermining the oil industry’s bargaining stance. The first development involved Libya, where under acute pressure from the government, the Italian State Oil Company, ENI, decided to formally initiate participation negotiations with the government. Further, in December 1971, the Libyan government decided to nationalise the holdings of British Petroleum on an altogether flimsy pretext. In the second important development, on June 1, 1972, Iraq nationalised the Iraq Petroleum Company (IPC). The government of Iraq maintained that its action was in response to the drastic loss of revenues from the Kirkuk oil field because of cutbacks in production. It claimed that this cutback cost the country $86 million in tax and royalty revenues.29 The companies argued that Kirkuk oil was no longer competitive due to lower European demand and increased tanker rates, so that the companies could not increase production as demanded by the government. This was rejected by the Iraqi government, which accused the oil industry of deliberately attempting to undermine the development of Iraq’s petroleum industry. OPEC labelled the steps taken by Iraq as “a lawful act of

sovereignty to safeguard its legitimate interests." The message was loud and clear to the oil industry regarding the likely consequences in the event that no resolution was quickly forthcoming on the tangled issue of participation.

A comprehensive agreement between OPEC and the oil industry, called the "General Agreement on Participation" was concluded on October 5, 1972 in New York and contained the following salient provisions:

1) It provided for a starting participation 25 percent to be increased to 30 percent on January 1, 1979; to 35 percent on January 1, 1980; 40 percent in January 1981; 45 percent in January 1982; reaching a level of 51 percent on January 1, 1983, where it was to remain till the expiry of the concessions.

2) The Gulf States agreed to pay for their equity share on the basis of net book value adjusted for inflation.

3) In order to facilitate the transfer of ownership with minimal disruption and least inconvenience to the parties concerned, the oil companies agreed to purchase the crude at or near market price.

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30 OPEC Official Resolutions, p 127.
This agreement had to be signed and ratified by at least three states, and the signatories had to negotiate separate agreements with their respective concessionaires. The carefully evolved compromise received a set back, when Libya, ever ploughing the lonely furrow, concluded a 50/50 joint venture with ENI. In any case the pendulum was swinging far too rapidly in favour of the oil producers to permit the implementation of these agreements as originally conceived.

In the aftermath of the Arab-Israeli war of October 1973, Iraq nationalised the holdings of Royal Dutch-Shell, Exxon and Mobil in the Basrah Petroleum Company. Iran in the summer of 1973 concluded an agreement with the Iranian Consortium which was tantamount to a 100 percent take-over; the foreign concessionaires were allowed to operate the consortium. By November 1973, OPEC itself had distanced itself from the original formulation by declaring the 51 percent limit as “insufficient and unsatisfactory.”

Under the new oil regime that came to be established in the aftermath of the Arab-Israeli war of October 1973, Saudi Arabia, Kuwait, Qatar and Abu Dhabi escalated their participation level to 60 percent in 1974; Kuwait

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negotiated a 100 percent take-over of the Kuwait Oil Company (KOC) in December 1975; and in the period 1975-1977, Qatar and Saudi Arabia also concluded 100 percent participation arrangements with their concessionaires.34

34 Ahrari, op cit, p 105.