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." 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. 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)**

<table>
<thead>
<tr>
<th></th>
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</thead>
<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>
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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

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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

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of 25 percent in the 1960s. 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.

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


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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.

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.\textsuperscript{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.\textsuperscript{12} The loss of Saudi Arabian oil on account of the closure of the Tapline combined with the implementation

\textsuperscript{11} For a detailed account, see Mosely, Leonard, Power Play: Oil in the Middle East (Random House, 1973), ch 24, pp.320-33
\textsuperscript{12} For a detailed account see, Terzian, Pierre, OPEC: The Inside Story (Zed Books London, 1985),pp.117-118
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.\(^\text{13}\)

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.\(^\text{14}\) 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.\(^\text{15}\)

\(^{13}\) Ahrari, op cit, p 35.

\(^{14}\) Choucri (1976), op cit, p 33.

\(^{15}\) 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.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

18 Terzian, op cit., pp 123-124. See also Skeet, op cit. pp 63-64.
terms of settlement for a period of five years.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.²⁰

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

¹⁹ ibid, pp 138-139. See also Skeet, op cit, pp67-68.
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

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23 Skeet, op cit, p. 71.
Tehran agreement.\textsuperscript{24}

\textit{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,\textsuperscript{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:\textsuperscript{26}

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

\textsuperscript{24} Ghanem, op cit, pp 128-132. See also Skeet, op cit, pp 72-73.
\textsuperscript{25} For a detailed account of these consultation see Skeet, op cit, pp 75-82.
\textsuperscript{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.  

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.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

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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. 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.\textsuperscript{34}

\textsuperscript{34} Ahrari, \textit{op cit}, p 105.