CHAPTER I

IMPORTANCE OF OIL

The agricultural and industrial development of the world has expanded and greatly prospered on the fossil fuels. First coal, and later natural gas and oil, provided the energy required. These fuels are deposits of solar energy transformed chemically by living things and progressively stored in minute amounts over the last 500 million years. It is on this finite amount of stored energy that modern man bases his current lifestyle.

The importance of oil has not always been as great as it is today. This importance may be attributed to the fact that the importance of any commodity depends on its requirement and availability. However, with the beginning of this century the importance and utility of oil has also been increasing day by day and it had started taking over coal as main source of energy. The rapid industrialisation in 20th century also played a significant role in enhancing the importance of oil. Oil was and is still needed almost in every core industry.

The invention of locomotive engine is considered as one of the most important achievements of mankind in the field of transportation. This invention not only increased the mobility of human being but it brought and introduced new avenues also. The movement of locomotive engine was dependent on coal as steam was the moving force, with passage of time oil -diesel engine to be more specific- replaced coal. Although, now, the electricity has
taken over the responsibility of moving the wheel, but in its production oil plays an important role.

In the second half of this century, particularly after the Second World War, the total energy consumption has risen four-fold, but the oil consumption in the same period has increased sixteen times.\(^1\) With the increasing demand of oil its importance also increased correspondingly.

From 1870 onwards, the world oil production has risen from 100 million tons in 1872 to 1000 million tons in 1890 and then the production doubled every ten years, from 1,000 million tons in 1960 to 2,000 million tons in 1970.\(^2\)

According to the available statistics (the proven coal reserves out weigh the oil reserves) there exist about 150 billion tons of oil compared to 700 billion tons of coal. But oil drilling is much cheaper, and less risky for human life, than digging coal. Hence the importance of oil.

Oil is the most versatile of all our energy resources that can be used to generate heat or empower internal combustion engines. The petrochemical industry provides synthetic fibres, plastics, and many industrial chemicals. The role of oil as a lubricant in a world of moving machinery is also crucial.

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2. Ibid.
The first commercial oil well as drilled in Pennsylvania in 1859, and additional wells were soon producing. By the end of nineteenth century oil was discovered in the Middle East and the region had started to play an important role in 'oil world' by the start of this century.\(^3\)

The increasing demand for oil is the result of heavy industrialisation, in the developed as well as developing world has caused oil to become the most important source of energy in the world. International oil has become a multibillion dollar industry that affects, in varying degrees, the balance of payments of oil exporting and consuming countries. Because of the Arab oil embargo, oil has inevitably been enmeshed into international political and economic relations and diplomatic activity.

The First World War transformed oil into a vital industrial and strategic raw material. For half a century petroleum had illuminated the world; now it began to propel the machines of war. The tanks, the planes, the trucks that helped the armies to fight the war were all moved by oil. Oil become a commodity of strategic importance as soon as various naval authorities realised oil's advantage over coal. "The war transformed oil from being a source of revenue for tycoons and speculators into a vital industrial and strategic material."\(^4\)

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When World War I broke out, the two major oil producers were the United States and Russia. Certain quantities of oil were also being obtained from Indonesia, Romania, and Mexico. On the eve of the war oil had been discovered in commercial quantities in Venezuela. During the war Russian oil faded from the world picture. During this period the attention of the world oil industry was concentrated on the more obviously promising areas, such as the United States, the Caribbean, the Middle East, and Indonesia. Europe and Africa were regarded with little interest.

As the war ended, the struggle for control of the Middle Eastern oil fields was followed by the formation of a cartel by the seven major oil companies - Standard Oil Company of New Jersey, Standard Oil of California, Secony-Vacuum Oil Company, Gulf Oil, Texas, Royal Dutch-Shell, and British Petroleum - the efforts of the companies to establish a monopoly over the production, refining, marketing, etc., of oil were aimed at establishing an international cartel to regulate prices and competition in such a way as to guarantee profits to all members of the cartel. At the end of World War I, Dutch-Shell was producing 84,000 barrels per day against Jersey Standard's 27,000. The two companies had a virtual monopoly in Egypt, Venezuela, and British Borneo; 96 per cent of production in the Dutch East Indies, and 11 per cent in Russia.

5. Ibid., p. 68.
Further, "...from 1922 onwards the United States produced more oil than its refineries could handle, and the refineries in turn pushed out more products than the market could absorb". 7 Important too were the new discoveries in Venezuela. From 2 million barrels in 1922, Venezuela's production rose to 9 million in 1924 and to 106 million in 1928, when it replaced Russia as the second largest producer in the world. In 1930 vast oil fields were discovered in Texas, which dropped prices from $1.30 a barrel to $0.5 a barrel. 8

The oil industry was established in several Middle Eastern countries before World War II. The total production of this region in 1938 amounted to about 15,000,000 tons.

As noted above, the First World War established petroleum as an essential war material. In World War II the need for petroleum and its products reached monumental proportions. In the railroad industry, steam locomotives had given way to diesel, and in the air the introduction of the DC-3 had led to the creation of a comprehensive airlines network. Undoubtedly oil played a vital role in winning the War, observed Prof. Edith Penrose:

In many ways the Second World War marks a turning point in the history of the industry, for after the war there was a steady decline in the control exercised by the major companies, but which became unmistakably evident in the later 1950s. 9

8. Ibid., pp. 77-78
World crude oil supplies were being boosted by major new supply sources. The great paradox of the international oil industry was that ever since the mid-1950s it had been facing a world surplus and declining prices. The reasons for this paradox were commercial and political.

The commercial reasons for the paradox have been described as follows:

The industry is not a monolithic whole; it is a collection of different companies with conflicting interests which have to compete with each other in order to earn their profits. Some ... have more oil than they need. But this is no consolation for Shell ... nor to ... the Italian ENI or French ERAP. For these groups the fact that there is a world surplus of oil is quite immaterial. It belongs to other people, and they want their own. Not even the reserve rich companies can afford to rest on their laurels... As ... the key to profitability in the international oil industry is to have a source of supply as close as possible.10

The political reasons for the paradox are based on past experiences with the Middle East, which is blessed with 75 percent of the world reserves and 46 percent of the production. Six of the world's ten leading oil-producing countries in 1968 had virtually no recorded output in 1925.11 The expansion in output of oil in the Middle East has been made possible by the discovery of huge oil reserves since the 1930s and by the continually rising demand for Middle Eastern Oil in Europe, Japan, the United States and other consuming countries.

10. Tugendhat, n. 2, pp. 166-8
11. Ibid., p. 165.
The economies of petroleum differ from those of other commodities in that crude oil prices are fixed administratively rather than determined by market conditions or by the forces of supply and demand. Over the decades oil has become more of an 'econostrategic' commodity than merely a commercial product. Oil trade is more politically oriented than any other business enterprise in the world; there is also the fact that the oil resources are located mostly in pre-industrial societies, which, naturally, take a sense of psychic and political satisfaction in seeing the industrial giants throb. Added to these is the pattern of oil production and consumption. In many cases oil production is almost entirely controlled by the host governments. The multinational oil companies had little or no financial incentives to diversify forces of the oil regions; rather they concentrated on cheap sources of oil in a few areas of the world. Gradually, a near monopoly production of oil was developed in the Middle East, neglecting other areas of the world.

FORMATION OF OPEC

Just a few months after the October 1973 Arab-Israel war, the Organization of Petroleum Exporting Countries (OPEC) became from a relatively unknown entity to a world famous body. The phenomenal rise in its prominence was the result of the oil embargo imposed by the Arabs against the United States and some European countries, which had supported their arch enemy-Israel.*

* OPEC was created in 1960, although the idea of combining within the framework of such an organisation was not a thought which came overnight. This idea had occupied the minds of experts and politicians in the oil exporting countries for more than a decade before.
Before the foundation of OPEC, the petroleum market, as noted above, was of the simple and traditional type in which the oil companies provided the supply and consuming countries the demand. The host countries had no share or place in this market, since their role was generally confined to offering the petroleum countries areas for exploitation against the payment of royalties. They did not participate in any meaningful way in the determination of production or of price levels. With the absence of producing countries from the scene, it was these companies that decided where and when the prospect for oil, it was these companies again that determined how much oil to produce once it was found, and it was these companies that, in the light of their assessment of the market, set the price at which it would be sold. Although the companies operating in each country were legally distinct, there was a pattern of interlocking ownership: British Petroleum (BP), Shell, Mobil, and Exxon were part-owners of the three companies operating in Iraq, Exxon, Texaco, California Standard, and Mobil jointly owned Aramco, which operating in Saudi Arabia; Exxon, Shell, and Gulf, through affiliates, operated separately in Venezuela; Gulf and BP jointly held the concession in Kuwait. Later all seven of them held shares in the Iranian Consortium that replaced British Petroleum after the crisis of 1951-54.

In the world at large in 1945-50, these 'Seven Sisters' controlled 65 per cent of proven resources of petroleum outside the Communist bloc, 55 percent of its production, 57 percent of all refinery capacity and major pipelines, and, through ownership
or long-term leases, at least 67 per cent of all privately owned tanker space. In short, the companies had all the assets necessary for the operation, growth, and control of the industry - they had the technical know-how, they had the necessary huge investments for the operation and growth of the complex industry, they controlled all the downstream operations, and they had the international markets for the oil produced.

Even before, but especially since World War II, the oil-producing countries realised the economic importance of their natural resource and started struggling with the companies to obtain better and larger returns from the companies.

In order to liberate themselves from the stranglehold of oil companies, the Arab oil-exporting countries thought of forming an organisation of their own.

This idea had been present, even, in the minds of the founders of the Arab League since 1945. But the officials realised at the time that the effectiveness of any grouping of countries that excluded Iran and Venezuela, both major oil producers and exporters, would be limited. In 1949 an important development took place in another part of the world - Venezuela. There appeared in Venezuela an economic study regarding its soil, prepared by Vice-President of a leading bank in which the then

Venezuelan oil minister drew attention to the competitive advantages of Middle East oil in comparison with Venezuelan oil, and suggested three courses of action:

1> Lowering the cost of Venezuelan oil by reversing Government oil policy;

2> Eliminating the principle of profit sharing introduced the year before; (*) and

3> Withholding the award of more social and economic benefits to Venezuelan workers. 14

This study led the Government of Venezuela to consider the coordination of its policy with the policies of the low cost oil-producing countries of the Middle East, in order to prevent the major oil companies from using Middle East oil to combat Venezuelan tax regulations. In September 1949 Venezuela sent a three-man delegation on an official visit to Saudi Arabia, Kuwait, Iraq, Egypt, Syria and Iran, to explain the advantages of formulating coordinated oil policies and to clarify the benefits to be gained by adopting the profit-sharing principle.

It was the first occasion on which co-ordination of efforts was discussed amongst the petroleum-exporting countries with a view to co-ordinating their positions and solving their common problems.

* In 1948 Venezuela imposed, through the enactment of a special tax law, on the companies operating in its territory the 50/50 profit-sharing principle.

OPEC's first Secretary-General, Faud Rouhani, says in describing the Venezuelan move that Venezuela decided to approach the oil-exporting countries in the Middle East in order to make allies instead of competitors in an area whose importance was rapidly increasing.\(^{15}\)

A period of stagnation followed lasting until 1957 when the Arab League Economic Council approved a resolution submitted by the Arab Oil Experts Committee calling for a petroleum Congress.

The first Arab Petroleum Congress was convened in Cairo in April 1959. This Congress was attended, beside Arab countries, by Venezuela and Iran. Important decisions were taken at this first Congress including the modifications of the 50/50 profit-sharing principle in the interest of the host countries. The Congress demanded the changes in the price structure should not be made without prior consultation with the governments of the oil-producing countries, and urged the oil-producing governments to consider the establishment of a common consultative board to facilitate the exchange of views on their common problems including the protection of their oil resources, production, exports and other matters.\(^{16}\)

\(^{15}\) Rouhani, n. 13, p. 76.

\(^{16}\) Ibid., p.77.
As it happens in international conferences, events occurring outside the Congress were more important than what happened inside. Between sessions, many meetings and discussions took place between the leading oilmen from the largest oil-exporting countries and these meetings resulted in the conclusion of a 'Gentleman's Agreement' by the delegation heads, including the Iranian and Venezuelan delegations. The Cairo deliberations and the principles embodied in the Gentleman's Agreement were the basis for the creation of OPEC.

Another important step towards the foundation of OPEC was the draft Arab agreement ratified in March 1960, six months before the foundation of the organisation, by a sub-committee of the Arab League Economic Council. Article 3 of this agreement stated that Arab oil-producing countries to co-ordinate their oil policies among themselves, and that there was nothing that could prevent them from co-operating with other oil-producing countries in the world, such as Iran and Venezuela, in view of their common interests and world market considerations.

The formal decision to establish an organisation of oil-exporting countries was taken in a meeting between Abdullah Tariki, Director General of Oil Affairs in Saudi Arabia at the time, and Perez Alfanso, Venezuela's Oil Minister, on May 13, 1960. A communique was issued after the meeting calling on the producing countries to follow a common petroleum policy to safeguard their legitimate rights.17

At this stage it would be useful to review briefly the factors that contributed towards the formation of the OPEC.

The most important direct cause that led to the founding of OPEC was the large reduction in posted prices* that took place in 1959 and 1960. This reduction in oil prices undermined the development plans of the producing countries in spite of the realisation of planned large increases in production which had been expected to boost budget revenues. The decrease in income per barrel thus came as a surprise and the first reduction of February 1959 raised a wave of public protest in the oil-exporting countries. Voices were raised demanding restraints on the companies' ability to control prices, and therefore the oil revenues of the producing countries. The fact that the governments concerned were not consulted before the price cuts were made aggravated the issue in spite of the fact that the companies were not, under the terms of their agreement obliged to consult the governments when making price alterations. Paul Frankel has described the position of exporting countries "like the wage earners of old, the exporting countries realised that they had to hang together or be hanged separately."18

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* This is a price that has been agreed between a producing country and the producing companies. In theory it should represent the price at which any purchaser of crude could obtain a supply where the price is posted. In fact, the posted price serves to calculate royalties and taxes on price. For details see Chevalier, Jean-Marie, *The New Oil Stakes*, (London, 1975).

Despite the strong position taken by the oil-exporting countries regarding any further reduction in their per barrel income through unilateral measures undertaken by the companies, the major companies went ahead and cut prices again in August 1960. The exporting countries responded by founding OPEC one month after this reduction.

First and the foremost indirect cause that paved the way for the foundation of OPEC was a growing awareness, particularly among the educated classes in the oil producing nations in the Middle East and Venezuela, about the importance of petroleum and its economies. The awakening of public opinion was aided by the appearance of a technocrats, educated and trained in the West, who attempted to draw their people's attention by writing and speaking to the importance of oil and the necessity of securing the rights of the producing countries from the foreign companies.

The spread of awareness and the persistent calls for the co-ordination of oil policies drove the Arab Governments, through their specialised organs, to translate this desires into a serious attempt to establish cooperation in oil affairs among the Arab countries. The various activities of the Arab League, such as meetings, studies and conferences, prepared the emotional framework and the right setting for the discussions that finally led to the creation of OPEC. An example of Arab moves undertaken within the framework of Arab League was the Iraqi Government's proposal submitted to the Arab League Economic Council in January 1959. The important points of the Iraqi proposal were:
a> Agreement on the adoption of common oil law.

b> Safeguarding Arab oil reserves, the maintenance of the level of oil prices through control of production and the co-ordination of the oil policies of the Arab producing countries with the oil policies of other countries.

c> Exchange of information and experts among Arab countries, and the unification of oil accounting systems.

d> Guaranteeing security of transit for Arab oil across Arab lands.

e> Establishment of an Oil Studies Institute attached to the Arab League.\(^{19}\)

The awareness about the importance of oil was more in comparatively advanced Venezuela. During the late forties and early fifties, Venezuela was far ahead in its tax legislation and financial arrangements with the oil companies. It was, however, anxious about competition from Middle East oil and the possibility that the companies might use the wide difference in the production costs of the two areas as a means of pressuring the Venezuelan Government. Venezuela therefore took great pains in mobilising Middle Eastern governments, and pressed them to demand more benefits and privileges from the companies operating on their lands. It also urged them to combine into an organisation that would look after their interests.

Till 10 September 1960, an organisation of oil producing countries existed only in minds, but stage was set for its formal announcement and the dream of 'oil-men unity' was coming true. At the invitation of the Government of Iraq representatives of the large oil-producing countries, Iran, Iraq, Kuwait, Saudi Arabia and Venezuela, convened in Baghdad during 10-14 September 1960, and as a result of their deliberations the Organization of Petroleum Exporting Countries was founded as a permanent organisation with international status by an agreement concluded between the participants of Baghdad Conference.

This agreement was registered as document No. 6363 in November 1962 with the Secretariat of the United Nations in accordance with Article 102 of the United Nations Charter. However, the act of registration did not confer on OPEC any specific status vis-à-vis the United Nations.20

20. Rouhani, n.13, p. 140