4th lesson: energy industry structure

Oil was discovered by Colonel Drake and William A. Smith in 1859. The oil industry has undergone four distinct phases between 1859 and 1960, when OPEC was formed. Here a brief description of the pre-OPEC and post-OPEC era is given.

1. Pre-OPEC Era :

The pre-OPEC Era was characterized by four phases: the oil rush, the phase of Standard Oil domination, the internationalization of the industry, and the rise of the Seven Sisters.

- **Phase 1: Oil Rush and Intense Competition (1859–1870):**

The discovery of oil in America led to an oil rush, with fortune seekers buying land and constructing oil derricks. This led to excessive drilling, wastage, and price fluctuations. Oil had limited use for lighting purposes, with kerosene produced by refining crude and sold to light homes and businesses. Horse-drawn wagons and railroads were primarily used for transporting crude oil to refineries.

- **Phase 2: Monopoly of Rockefeller Company (1911–1928):**

John D. Rockefeller dominated the oil industry by controlling bottleneck facilities such as refining, transportation, and distribution. He set up the Standard Oil Company in 1870, which gained control of 90-95% of refining in the United States through aggressive mergers between 1870 and 1880. However, Standard Oil's dominant position came under threat from several developments.

- **Phase 3: Internationalization of Oil Industry (1911–1928):**

Oil began to displace coal as the dominant fuel in the world economy. The maturity of the automobile industry spurred demand for gasoline, and the break out of the First World War fuelled oil demand for military and other services. State intervention in the oil business started with the British Government acquiring 51% of the Anglo-Persian Oil Company (renamed as the British Petroleum).

The beginning of the Mexican Revolution in 1911 created an uncertain political situation in Mexico, and the new constitution of 1917 gave ownership of subsoil resources to the state. This affected investor confidence in Mexico, leading to higher production costs, increasing taxation, and exhaustion of existing fields.

In response to increased dependence on oil after World War I, oil companies began investing in new crude oil production, leading to a glut in world oil supplies by 1928 and a drastic fall in prices. The Achnacarry Accord of 1928 stabilized the market, but the American market was excluded.

- **Phase 4: Between 1928 and 1960: Rise of the Seven Sisters:**

Between 1928 and 1960, significant developments changed the oil industry, including the greater assertiveness of host governments in oil affairs, the nationalization of Mexico's oil industry, and the rise of the Seven Sisters. The Middle East emerged as a focal point due to its reserve potential, but oil companies failed to regulate the market due to factors beyond their control. New entry into the Middle East and production outside these regions continued to grow, with Venezuela becoming a major producer in South America. Major oil companies operating in the Middle East worked in joint operating arrangements. Oil exporting countries began to claim a bigger share of oil profit and sovereignty over the oil beneath the ground. In 1943, Venezuela obtained a 50-50 split of profits, becoming the industry norm. The importance of oil continued to grow, and during World War II, oil played an important role. Seven international, integrated oil companies dominated the oil scene, controlling the entire supply chain and influencing the market.

2. OPEC Era:

The Organization of the Petroleum Exporting Countries (OPEC) was established in Iraq in 1960 by five leading oil producing states to coordinate petroleum policies and secure fair remuneration for their outputs. At its peak, OPEC had 14 members but now has 12 full members. The organization was established during a time when Middle Eastern production was rising but the market price was falling or stable. This period also saw the emergence of new independent states through decolonization, with one of their aspirations being to exert control over their resources for economic and social development. The OPEC Era can be divided into several phases.

- **Phase 1: 1960–1973 :**

The first phase saw OPEC members disunite and achieve moderate gains. It focused on tax system changes, production control, and steps towards nationalization of concessions. The 1968 Manifesto provided the blueprint for nationalization of concessions, encouraging the creation of national oil companies to develop oil reserves and national participation in concessions.

Towards the end of this period, political events such as Algerian independence, Israeli victory in the 1967 war, Libyan monarchy overturning, and higher oil sales prices led to OPEC negotiations forcing price increases and increased tax rates.

- **Phase 2: 1973–1975 :**

The second phase coincided with a more assertive role of OPEC, with Arab producers imposing oil embargos against countries like the USA, Holland, Portugal, and South Africa, cutting oil production, and declaring unilateral tax reference prices. This led to the first oil price shock, which led importers to look for alternative options and the use of domestic fuels. Coal was often preferred, and energy efficiency and demand management options were considered for the first time.

- **Phase 3: 1975–1981 :**

OPEC policies between 1975 and 1978 aimed at demand stabilization and moderate price increase. However, historical events such as the Iranian revolution and the Iran-Iraq war significantly influenced OPEC policies. Oil production stopped in these countries, leading to a second wave of price rise that sent shock waves around the world. This resulted in 25% of OPEC oil being sold in the spot market and some members annulling long-term contracts.

- **Phase 4: (1981-1986):**

It saw importing countries reduce consumption and search for alternatives, with non-OPEC oil becoming more popular. OPEC decided to fix a $34 per barrel price, initiating a 10% reduction in production in 1981 and introducing production quotas in 1982. However, disagreements surfaced in 1983 for new quotas, and Saudi Arabia decided to act as the swing producer to control prices. The market share of OPEC members declined rapidly, reaching close to 20% from a high of above 50% in 1973.

The third oil shock or counter shock occurred when Saudi Arabia decided not to support any further production cuts, leading to prices falling to $15, $10, and $7 in July 1986.

- **Phase 5: OPEC in the 1990s :**

In the post-1986 period, the glut in the market continued, negatively impacting the viability of costly oil production in non-OPEC countries and energy diversification initiatives. Major events during this period included liberalization and market restructuring, the collapse of the Soviet Union, the Iraqi invasion of Kuwait, and the Asian economic crisis in 1997.

During this period, OPEC worked through quota adjustments and supply adjustments to maintain a reasonable price level for oil, but non-OPEC members continued to dominate the supply. This situation encouraged members to produce beyond their quotas, making it difficult for OPEC to ensure strict adherence to its quota policy.