History of OPEC

The Rise of OPEC

The Organization of the Petroleum Exporting Countries (OPEC) was created at the Baghdad Conference in Iraq in September 1960. The founding members of the organization were Iran, Iraq, Kuwait, Saudi Arabia and Venezuela. These five states were later joined by eight other countries: Qatar (1961), Indonesia (1962), Libya (1962), United Arab Emirates (1967), Algeria (1969), Nigeria (1971), Ecuador (1973), and Gabon (1975). Ecuador and Gabon withdrew from the organization in 1992 and 1994, respectively.

The purpose of OPEC, as with any cartel, is to limit supplies in the hope of keeping prices high. The oil industry has been plagued by production booms and falling prices ever since Colonel Drakes' discovery of oil at Titusville, Pennsylvania in 1859. Just as the major oil companies colluded from the 1920's to the 1960's to prevent prices (and profits) from falling, members of OPEC meet on a regular basis to set production levels in the hope of maintaining prices. The essential nature of oil (no substitutes) coupled with its limited number of suppliers make it the ideal product for cartelization.

The rise of OPEC is tied to a shifting balance of power from the multinational oil companies to the oil producing countries. Lacking exploration skills, production technology, refining capacity, and distribution networks, oil producing countries were unable to challenge the dominance of the oil companies prior to World War II. Although Mexico wrestled control of its oil industry from foreigners in 1938, it quickly receded from the lucrative international market due to insufficient capital for investment. However, about the time of World War II the oil exporting countries began seeking better terms in their oil contracts. In 1943 Venezuela signed the first "fifty-fifty principle" agreement which provided oil producers with a lump sum royalty plus a fifty-fifty split of profits (i.e., selling price minus production cost).

In the late 1940's Venezuela revised their tax system to capture a greater share of the oil profits. The oil companies responded to this move by shifting oil purchases to countries with cheaper contracts. In response, Venezuela contacted Arab producers and encouraged them to demand similar "fifty-fifty" deals and reform their tax systems. Saudi Arabia, seeing the value of the fifty-fifty contract and understanding the power of acting collectively, quickly demanded and received a similar contract from Aramco.

In 1947, the Iranian Parliament passed a law demanding the termination of previous agreements with Anglo-Iran (referred to as Anglo-Persian prior to 1935 and British Petroleum after 1954). When negotiations failed to lead to a compromise, Iranian Prime Minister Mossadegh nationalized oil operations by the in May 1951. The collapse of the oil industry pushed the economy into chaos. Domestic opponents, aided by the American Central Intelligence Agency, were able to topple Mossadegh in 1953. A new British-Iranian agreement was signed the following year. The newly restored Shah of Iran became a pillar of American middle east policy until the Iranian Revolution in 1979.

While world oil demand grew during the 1950s, they were outpaced by the growth in production. The problem was exacerbated by the fact that the "fifty-fifty" deals were based on "posted" prices rather than "market" prices. (See Table 1 from Danielsen 1982, 136). Given that posted prices were fixed, oil

producing countries had an incentive to grant additional concessions to expand oil revenue. Market prices became divorced from their calculations. The increases in supply drove market prices even further down and eroded the profits of the multinational oil companies.

The downward push on prices led to a policy debate in Washington. Although the United States had been a net exporter of oil until 1948, the expansion of cheaply produced oil from the middle east led to rising imports. As prices fell, domestic producers simply could not compete. Moreover, the Eisenhower Administration concluded (as the Japanese had prior to World War II), dependence on foreign oil placed the country's national security in jeopardy. The U.S. responded with an import quota. The quota kept domestic prices artificially high and represented a net transfer of wealth from American oil consumers to American oil producers. By 1970, the world price of oil was $1.30 and the domestic price of oil was $3.18 (Danielsen 1982, 150).

In order to recapture profits, the multinational oil companies tried to cut the "posted" price from 1958 onward. In 1959, British Petroleum unilaterally cut oil prices by about 10 percent. It instantly set off denunciation from the oil exporting countries. In 1960, after a second cut in the posted price in August, the five major oil producing countries responded by forming the Organization of Petroleum Exporting Countries in September(OPEC).

During its first decade, OPEC was able to halt the free fall in prices. However, it was not able to raise prices as most members had hoped. In general, commodity cartels (such as the tin cartel or the coffee cartel) collapse because there are many substitutes for the product or there are many potential producers of the product. A cartel inspired rise in coffee prices triggers some consumers to switch to hot tea (i.e., demand falls) and encourages new producers to enter the market (i.e., supply rises). Both the fall in demand and the rise in supply put downward pressure on prices and undermine the cartel's effectiveness.

Cartels also suffer from a "collective action problem." That is, every member has an incentive to cheat on the cartel by increasing its production. For example, an individual country such as Iran can increase its oil revenues by expanding production *as long as all other members stick to their quotas*. However, all members have a similar incentive to increase production -- i.e., they all want to free ride on the collective good. The incentive to cheat implies that cartels are traditionally short-lived enterprises.

Although the essential nature of oil and the limited number of suppliers worked in the OPEC's favor, the power of the organization remained limited during the first decade for five reasons. First, OPEC's share of world production was only 28% in 1960. By 1970, this figure would rise to 41%. (See Table 2 for OPEC share of world production and Table 3 for the distribution of output among OPEC members. Both tables are from Danielsen 1982, 131-132). Second, the fact that the oil reserves in the ground belonged to the multinational corporations (except in Iran)limited the power of the oil producing countries. Third, the oil glut of the 1960's made any threat to raise prices incredible. Fourth, the oil exporting countries were desperate for revenue to fuel economic development. Sixth, important political divisions existed in the Arab world. The revolutionary government of Nasser repeatedly clashed with the Saudi monarchy. Iraq threatened to invade its neighbor Kuwait (it was deterred by the deployment of British forces). Iran and Saudi Arabia vied for leadership of the Middle East.

The First Oil Shock

OPEC's fortunes began to shift in the early 1970's as rising demand for oil began to outstrip production. Moreover, the oil producing states began demanding further concessions. Muammar al-Qaddafi, after seizing power in military coup in Libya, demanded and received a 20 percent increase in royalties, a "55-45" profit sharing agreement, and tax concessions (Yergin 1991, 580). This move triggered a series of new demands that ratcheted up oil prices and oil exporting country profits.

As the world oil market tightened, the Arab world became more vocal in calling for use of the oil weapon to achieve their economic and political objectives. This was most acutely realized in the oil embargo during the 1973 October War between Egypt and Israel. Saudi Arabia refused to increase production in order to halt rising prices unless the U.S. backed the Arab position. Arab oil ministers than agreed to an embargo to further their political objectives. Productin would be cut by 5 percent per month until the West backed down. States adopting a "freindly" position (from the Arab perspective) would be unaffected. When Nixon publicly proposed a $2.2 billion military aid package for Israel, Arab states began an oil embargo against the United States (later expanded to the Netherlands, Portugal, South Africa, and Rhodesia).

The new official price was agreed among OPEC member countries: $11.65. As Figure 1, which displays historical oil prices from 1920-present, shows the jump in prices was unprecedented. Oil prices jump from about $3.00 a barrel before the war to $11.65. The embargo, which did not end until the Syrian-Israeli disengagement was secured, drove the world economy into deep recession. Gross national product in the U.S. declines by 6 percent in the following two years. The Japanese economy shrinks for the first time since the Second World War (Yergin 1991).

The Second Oil Shock

The Second Oil Shock began when the Iranian Revolution and ensuing halt of Iranian petroleum exports had caused panic and speculations in the world oil market. When the Carter administration placed an embargo on the importing of Iranian oil into the United States and froze Iranian assets in response to the hostage taking, Iran counterattacked by prohibiting the exporting of Iranian oil to any American firm. Moreover, the outbreak of the war between Iran and Iraq in 1980 shook the oil market as well. In its initial stage, the Iran-Iraq war abruptly removed almost 4 million daily barrels of oil from the world market—15 percent of total OPEC output and 8 percent of free world demand. In 1980 OPEC representatives (with the exception of Saudi Arabia) agreed to set prices at thirty-six dollar a barrel As Figure 1 again shows the jump in prices was unprecedented.

However, the impact of the Second Oil Shock turned out to be short-lived. The influence of OPEC appeared to be diminishing as the production by Mexico, Britain, Norway, and other non-OPEC countries and Alaska was continuing to increase. Anxious to increase market share, they were making significant cuts in their official prices. As a result, OPEC's share of world output quickly fell by 27 percent (Yergin 1991). As Table 4 shows, oil revenues for OPEC members plunged after 1981. Saudi Arabia, the largest producer in OPEC, saw its oil revenues plunge from $113.2 billion in 1981 to just $20.0 billion in 1986.

Although the Second Oil Shock sent the developed world into recession, the most serious long run impact of the second shock was in the developing world. During the 1970s, the oil producing states placed a significant portion of their revenue into commercial banks because they simply could not spend the money as fast as it came in. The commercial banks loaned this money to developing countries which hoped to repay the loans with revenue from their rapidly growing economies. However, the developed world responded to the Second Oil Shock by rapidly raising interest rates which deepened the on-going recessions. The developing countries saw exports fall, oil import prices rise, and interest payments skyrocket. The result was the debt crisis which first appeared in Mexico in 1982 and quickly spread throughout the developing world. In the "lost decade" of the 1980's, years of hard fought economic gains were wiped out. From 1980-88, the real income of mecian workers fell by 40 percent (Lairson and Skidmore 1993, 277).

Since early 1980s, the world petroleum market confronted the OPEC with an unpalatable choice: cut prices to regain markets or cut production to maintain price. However, the OPEC countries did not want to reduce prices, for fear that they would undermine their whole pricing structure, lose their great economic and political gains, and so diminish their political influence. OPEC did not always organize a united front against this pressure. For example, Saudi Arabia, whose oil production far surpassed other member countries, had championed decisions for low pricing for larger market-sharing and long-term gains.

The Persian Gulf War

The third major price spike in Figure 1 occurred in 1990-1 when Iraq invaded its fellow OPEC member Kuwait. Iraq had long claimed the territory of Kuwait; in 1961 it appeared Iraq was going to swallow its tiny neighbor until the dispatch of troops by the British. In 1991 the on-going territorial conflict was exacerbated by two oil issues: (1) the continued pumping of oil by Kuwait from a field located under both countries; and (2)low oil revenues for Iraq which made paying off its war debts (to Kuwait and others) difficult. A successful invasion would expand reserves, augment Iraqi power in OPEC, raise oil prices and revenue, and annul war debts to Kuwait.

Iraq gambled that the U.S. response would be political and economic. However, the Iraqi invasion triggered a military response which was supported by an unlikely coalition of western, developing, communist, and Arab states. The sudden removal of two major producers, Kuwait and Iraq, could have sent oil prices through the ceiling. However, Saudi Arabia expanded production by literally millions of barrels per day to keep prices from rising a great deal. Since the war, Iraq's refusal to comply with United Nations resolutions has resulted in the continuation of an oil embargo.

The Future of OPEC

In any cartel, success in the short run sets in motion events which make maintaining success nearly impossible. A successful cartel raises prices which encourages consumers to cut demand and potential producers to enter the market. The success of OPEC in the 1970s triggered conservation, substitution, and new production in the 1980s.

While oil prices are currently at record lows in real terms (i.e., controlling for inflation), it is clear that

demand for oil will continue to rise. Moreover, the lack of major oil finds in the last twenty years implies (but obviously does not guarantee) that supply will grow only slowly. Unless a cheap alternative source of energy is discovered in the meantime, this combination of effects will create an environment conducive to cartelization.

Further Reading

For a summary of OPEC activities in the 1990s directly from the organization itself, see Recent History on the OPEC web page (www.opec.org).

Updated: 1 September 1998
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