CHAPTER II

HISTORY OF RISING OIL PRICES

A. 1973 Oil Crisis: Yom Kippur War

The 1973 oil crisis began in earnest on October 17, 1973 resulted from the Arab -Israeli War. The persistence of conflict finally triggered a response that transformed OPEC from a mere cartel into a formidable political force. After the Six Day War of 1967 the Arab members of OPEC formed a separate, overlapping group (Organization of Arab Petroleum Exporting Countries) for the purpose of centering policy and exerting pressure on the West over its support of Israel. Egypt and Syria, though not major oil-exporting countries, joined the latter grouping to help articulate its objectives. Later, the Yom Kippur War of 1973 galvanized Arab opinion. During the war the Arab world imposed the 1973 oil embargo against the United States, Western Europe, and Japan. By the early 1970s the great Western oil conglomerates suddenly faced a unified bloc of producers. The oil prices spiraled well above the initial 70% increase.

The effects of the embargo were immediate. OPEC forced the oil companies to increase payments drastically. The price of oil quadrupled by 1974 to nearly $12 per US barrel (75 $\$/m^3$)[8]. This increase in the price of oil had a dramatic effect on oil exporting nations, for the countries of the Middle East who had long been

[8] "The price of oil - in Context," 18 April 2006, www.cbc.ca/money/story/2006/04/18/oil-060418.html.

dominated by the industrial powers were seen to have acquired control of a vital commodity. Some of the income was dispensed in the form of aid to other underdeveloped nations whose economies had been caught between higher prices of oil and lower prices for their own export commodities and raw materials amid shrinking Western demand for their goods. Much was absorbed in massive arms purchases that exacerbated political tensions, particularly in the Middle East.

Meanwhile, the shock produced chaos in the United States, the retail price of a gallon of gasoline rose from a national average of 38.5 cents in May 1973 to 55.1 cents in June 1974. Meanwhile, New York Stock Exchange shares lost $97 billion in value in six weeks.Daily consumption dropped by 6.1% from September to February, and by the summer of 1974, by 7% as the United States suffered its first fuel shortage since the Second World War. Similarly, underscoring the interdependence of the world societies and economies, oil-importing nations in the noncommunist industrial world saw sudden inflation and economic recession.

In brief, this was the first oil shock directly resulted from the Arab-Israeli War, some analysts commented that the war caused further “changes in the structure of the oil industry and the alignment of political power in the Middle East”[9].

[9] Stock Joe, “Middle East Oil and the Energy Crisis,” Monthly Review Press , NY, 1975.

B. Crisis in Iran and Iraq (1979-1980)

The second of oil crisis occurred in the wake of Iranian revolution. Amid massive protests, the Shah of Iran, Mohammad Reza Pahlavi, fled his country in early 1979, allowing Ayatollah Khomeini to gain control. The protests shattered the Iranian oil sector. While the new regime resumed oil exports, it was inconsistent and at a lower volume, forcing up prices. Saudi Arabia and other OPEC nations increased production to offset the decline, and the overall loss in production was about 4%. However, a widespread panic resulted, driving the price far higher than would be expected under normal circumstances. Following the crisis in Iran, the oil prices had kept considerably high due to the Iraq –Iran War during 1980-1981 when Saddam attacked Iran, as a response to Iran assisting Kurd's separatist movement. Iran, as the second's world producer of oil, ceased the production, resulting oil shortage in the world market.

Elaborately, events in Iran and Iraq led to another round of crude oil price increases in 1979 and 1980. The Iranian revolution resulted in the loss of 2 to 2.5 million barrels of oil per day between November, 1978 and June, 1979. At one point production almost halted. In the same way, Iraq invaded Iran in September, 1980 by November the combined production of both countries was only a million barrels per day and 6.5 million barrels per day less than a year before. Worldwide crude oil production was 10 percent lower than in 1979. According to the statistic report[10], the

[10] James L. Williams, "Oil Prices History and Analysis," WTRG Economics 2006, http://www.wtrg.com/prices.htm.

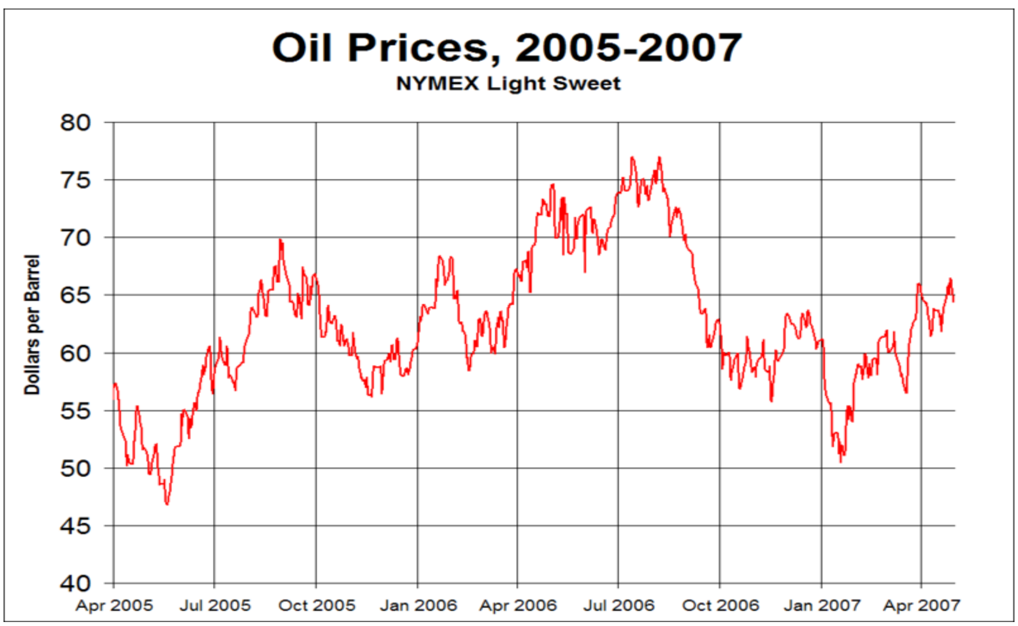
combination of two events resulted in crude oil prices more than doubling from $14 in 1978 to $35 per barrel in 1981.

C. Gulf War (1990-1991)

The Gulf war was another factor leading to oil crisis. It broke out in 1990 as Iraq invaded and attempted to seize oil field in Kuwait with an accusation that Kuwait sold crude oil cheaper than reality price, which cost $14 million loss of profit to Iraq. On June 2nd 1990, Iraqi army under Saddam presidency took control over oil field. With an effort to keep peace of the world, the United Nations applied diplomatic means to settle the dispute, but this endeavor was a failure. Hence, on January 15, 1991 the UN army responded militarily by Operation Dessert Storm and Operation Dessert Sabre and was finally be able to remove Saddam's army out of Kuwait. However, destruction remains as Iraq had burnt and destroyed many of oil fields in Kuwait. The unrest in Middle East affected in a higher oil price. OAPEC decided that since the oil production in the Kuwait was falling, that they would increase their oil supply and stabilized the oil market. Oil hit a then-record $40.42 per barrel during this crisis.

4. Increase of Oil Prices (2004- 2006)

The recent experience of the rapid rising of oil price was occurred during 2004 up to 2006. According to statistics[11], the price of crude oil was steadily increasing, reaching US $40 to US $50 per barrel by September 2004. Crude oil prices surged to a record high above $60 a barrel in June 2005, sustaining a rally built on strong demand for gasoline and diesel and on concerns about refiners' ability to keep up. This trend continued into early August 2005 and peaked at a close of over $77 a barrel in July 2006. Later, in December 2006, the price decreased to about $63. The graph as below evidently shows the fluctuation of oil price during the recent period since April 2005.



[11] Statistic of the oil price standard from New York Mercantile Exchange, http://ww.wikipedia.org.

**Source: Daily oil prices of New York Mercantile Exchange (NYMEX) Light Sweet Crude

<u>**Causes of Oil Price Increase**</u>

According to many experts, the current situation of oil price was caused by several factors. The causes of oil price increase are as following:

1. Current situation and political instability - - generating such political uncertainty as, on going wars, natural disaster, labor strike, terrorist threat or natural disasters. There are other factors contributing to the price spike, usually involving current issues that would have an impact on energy production, supply and investment. Some people argue that hurricane threats, such as Katherina an Lita, to oil platforms, fires and terrorist threats at refineries, or even on going wars in Iraq or Lebanon and other general problems are responsible for the higher gas prices. Critics argue that these problems periodically push price higher, but that they are not fundamental or long term enough to cause the large jump in gas price. Most of the known oil reserves are in one part of the world, i.e. West Asia (or the Middle East). The other major petroleum exporting countries are Russia, Nigeria, Indonesia and Venezuela. These countries have been politically unstable in the recent past and this has also led to the oil traders demanding a premium

2. Rise in global demand from industrialized countries - - particularly China and India. Another reason contributing to a price spike is a rapid industrialization which leads to growing consumption and demand for oil throughout the globe. The most contributing factor to the new crisis, apparently, is the growing rate of oil consumption in China. It is evident that China has acquired a fast growing economy, illustrated by a red hot growing rate of around 9-10% recently, leading to an increase in a total global demand, which makes the price to further rise accordingly. Referring to the news article, it articulates that "China's growing thirst for oil -- plus strong demand for gasoline in the U.S. and fears of supply disruptions in the Persian Gulf -- has driven oil prices to their highest levels since oil futures started trading on the New York Mercantile Exchange in 1983. The price for U.S. benchmark oil for June delivery settled at $41.08 Thursday, up 31 cents from Wednesday”. The same phenomenon also mirrors what is taking place in India, for now the country consumes more oil that ever, as the research has shown that in Indian demand for petroleum products will probably increase by an average of between 4 and 4.5 % per year over the five years between 2002 and 2007

3. Lack of energy efficiency - - This is related to over consumption of energy by the world in the last decades. Lack of energy efficiency has markedly been problematic in involving areas, generally in industry and transportation. Statistics shows that transport consumes more energy than industry: 35 % of total consumption 60 % of which is from oil importation However, it is mainly an urban problem: 50 % of energy is consumed in towns. Moreover, 96% of transport energy comes from oil products, which are the main pollutants. This dependence is in danger of posing serious long-term problems by making transport dependent on a fragile and production that is in short supply. Also, rise in demand is reflected in a shift in individual preferences in their vehicles. In United States, the number one oil consuming countries, SUV or other high fuel consumption cars have replaced mini or economical autos, because of formerly cheap oil, compared to living costs in United States.

4. The Hubbert peak theory - - also known as "**peak oil**", concerns the long-term rate of extraction and depletion in conventional petroleum and other fossil fuels. It is named after American geophysicist Marion King Hubbert, who created a model of known oil reserves, and proposed, in a paper he presented to the American Petroleum Institute in 1956, that oil production would peak in the continental United States between 1965 and 1970, and worldwide in 2000.

United States oil production peaked in 1971. The peak of world oilfield *discoveries* occurred in 1962. Some estimates for the date of worldwide peak in oil production, made by Hubbert and others, have already passed. This has led to criticism of the theory's method and predictions. Supporters of peak theory suggest Hubbert's model did not account for the 1973 and 1979 OPEC oil shocks, which effectively reduced demand, thus delaying a world peak.

5. Speculation - - others believe that the price of oil is almost entirely speculative, and that the increase in price is due to oil speculation extending into the long term. These people argue that speculators foresee increasing demand, decreasing supply, or both, leading to a long term increase in the price of oil. If these speculators are wrong, current prices may actually be a price bubble, and the price could thus collapse. A July 14, 2005 Morgan Stanley report[7] suggests that opinions of the oil market could burst just like a bubble if indications of declining Asian demand continue. See also How derivatives drive oil prices up, despite ample supply in physical oil market).

New Role of Oil MNC in an International Arena

The effects of costly energy price has contributed to the newly emergent role of the Big Oil companies in an international stage, where state is no long the only important actor. The Big Oil usually comes from the first-world industrial society and member companies include member of “Seven Sisters”. Historically the Seven Sisters is the term coined by an Italian entrepreneur, Enrico Mattei. With their virtual monopoly on oil production, refinement and distribution, they were able to take advantage of the rapidly increasing demands for oil and turn massive profits. Being well organized and able to negotiate as a cartel, they were able to have their way in most Third World oil producers.

The companies are:

1. Standard Oil of New Jersey (Esso). This later became Exxon, now ExxonMobil.
2. Royal Dutch Shell Anglo-Dutch
3. British Anglo-Persian Oil Company (APOC). This later became British Petroleum, then BP Amoco following a merger with Amoco (which in

turn was formerly Standard Oil of Indiana). It is now known solely by the initials BP.

4. Standard Oil of New York (Socony). This later became Mobil, which merged with Exxon to form ExxonMobil.
5. Texaco. This later merged with Chevron and was ChevronTexaco from 2001 till 2005 when the name of the company reverted back to Chevron.
6. Standard Oil of California (Socal). This became Chevron.
7. Gulf Oil. Most of this became part of Chevron, with smaller parts becoming part of BP, and Cumberland Farms. A network of stations in the northeastern United States still bears this name (http://www.answers.com/topic/seven-sisters-oil-companies)

Besides, these aforementioned companies, other national oil companies from other countries also play a pivotal role in the politics of oil ,and are, however, recognized by many as a mechanism or instrument in which the major powers utilize , for exploitation of natural resources in the Third world or in oil- rich countries. Thought known to be run by individuals from the private sector, these companies are politically influenced and often controlled by and for the sake of powerful states. Their engagement entails in struggle for oil, as these state controlled firms compete for new energy resources to secure national demand for oil in the time to come.

Moreover, as witnessed national oil companies are increasingly venturing beyond their home country's borders in search of reserves. The governments' motives are varied, but in cases such as China and India, for instance, they are seeking more secure oil supplies to meet the needs of their fast-growing economies. The conquest for oil is expanded from Middle East to Central Asia and Africa, thus causing elevation of tensions among oil searching states, with shared aspirations for discovery of new source of oil. Regarding conflict over this issue, it brings about great concern in hi politics, when the US senate undertook parliamentary debate over China's bid for Unocal, which was later denied, due to American's security and economic concerns.