The Future World Oil Market: State of Nature or Social Contract?

[This is a comment on an article by Mary Ann Tétreault, published in the *Oxford Energy Forum* n° 39, oct. 1999, entitled "The philosophy of upstream reorganisation".]

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Mary Ann Tétreault develops a very interesting interpretation of the emerging new relationship between international oil companies and Middle East producing countries. The original intellectual tools she handles—concepts drawn from the European political philosophy tradition—allow her to argue as follows: (1) the oil market left to itself—whether participants are states or firms—behaves like a Hobbesian "state of nature" often resulting in a situation damaging to each participant; (2) to deal with it, the international oil community has historically relied on different types of organisations, but these *social contracts* or "republics"—as Tetreault sees them—were inherently unstable since they rested on too narrowly defined interests; (3) the rationale behind the possible return of oil companies to the richest Middle East countries is the search for new "international oil republics" able to "offer greater security and higher profits for all the good republicans among them".

The market as a state of nature, revisited

Let us start with a discussion of the concepts themselves. How are we to understand the idea that the market is a *state of nature*? It is disputable that the way classical philosophers imagine the cohabitation between individuals in the state of nature fits that of actors engaged in an economic activity. Indeed, at the very core of the social contract political theory—whether in the liberal Lockean tradition, the absolutist Hobbesian one, or the Rousseauiste critique of the latter—is the idea that a sovereign power is required as a prerequisite to any lasting collective order. What about the market? The order emerging out of the market process *does* require such an authority, powerful enough to enforce contracts and to "sanctify" property rights. It is clearly shown from Adam Smith's *Wealth of Nations*, to contemporary neoliberals such as Friedrich Hayek, Ludwig von Mises, and political philosophers such as Robert Nozick. The market process, even for the arch-free-marketers, *cannot* take place in a state of nature.

But M.A. Tétreault still has a point: we can infer (e.g. from the two savages' hunting party in Rousseau's *On the Origin Of Inequality*) a less tragic version of the state of nature. The problem associated with the lack of sovereign authority is no longer one of civil war and peace, but one of coordination between individuals engaged in a collective action. Had Rousseau's hunters been bound by a "social contract", they could have directed their individual efforts to a more rewarding collective result; the defective coordination arises from unlimited freedom of action. Arguably, a market may here be seen as a "state of nature", as opposed to an organisation where individuals are *under contract*—i.e. bound by a set of rules designed by reference to a collective goal. (French

sociologist Raymond Boudon has suggested such a qualification of the market as a state of nature; see his *Unintended Consequences of Social Action*, Macmillan, 1982.) But if we accept such a qualification, two points should immediately be made:

- Many such "states of nature" persist once the political community has empowered a sovereign authority—when a social contract has taken the collective life *out* of the (Hobbesian) state of nature. In fact, such "states of nature" are a commonplace feature of modern social life. The innumerable producers competing on, say, the market for *baguettes* in Paris, interact with each other in what Tétreault and Boudon would call a "state of nature": no authority ensures that the behaviour of any one of them remains compatible with the interests of any other, let alone with the common interest of the bakers as a group.
- Those "states of nature" are widely seen as beneficial to the society and the economy. The only task of an antitrust authority is to make sure "states of nature" prevail and are not discreetly replaced by "social contracts". For the other name of Tétreault's "state of nature" is the *competitive process*. Of course, economic agents often (always?) find it hard to live in a "state of nature"; unfortunately that is precisely the reason why society wants them all to remain in such a state. Adam Smith's *invisible hand*, far from neglecting that the market is a state of nature—as M.A. Tétreault seems to imply—is based on it.

The idea that the market behaves like a "state of nature" can only be understood with reference to the second acceptation—the *sociological* one, so to speak. But to contend that such a "state of nature" is damaging and should be replaced by something else is not correct. It borrows the pejorative aspect of the *political* state of nature, which refers to something very different—the war of everyone against everybody, in Hobbes' words. Behind these unusual words, as we shall now see, lies the common debate about competition in the oil market.

The competitive process: between constraint and emancipation

The history of the oil market—even before it became international—can be viewed as a never-ending contest between the efforts of participants to enter into some form of "social contract", and the natural drive towards a "state of nature". The former has historically prevailed, to such a point that many have argued that competition is not sustainable in the oil industry—mainly because of the costs structure—and that producers engaging in joint industry planning perform a task of *intérêt général*. Among them is Paul Frankel and other economists from the business, as well as many governmental and pro-OPEC analysts from 1970 onwards. M.A. Adelman—with a few others—has spent an entire academic life demonstrating that competition is not only possible but highly desirable—at least to final consumers—even if the competitive process has indeed often been constrained.

Since the end of the 1970s (or early 1980s), the market process seems to be winning its old contest against planning. Few would deny that it is now firmly established in the driving seat; competition is the prime mover of the industry dynamics. Yet fifteen years of market process dominance have left us with a far from competitive world oil market. The reason is that a handful of producers are still loosely bound by a "social contract" dedicated to market control. The quota system is dead, along with the formal cartel; but

the prize is high enough to make unilateral restriction rewarding, and to allow some collective actions like the one we are currently experiencing. The result is a market more erratic than ever, where periods of rapid move of prices toward costs alternate with sharp but short-lived upward swings.

In the late 1980s and early 1990s, many were claiming a new age in international oil relations, one of far-reaching cooperation rather than confrontation, of "constructive" dialogue rather than "destructive" pursuit of self-interest. Many saw the downstream investments of national oil companies from OPEC countries as a first step toward this new oil order. Indeed, vertical re-integration was often perceived as a prerequisite to the coming of an *âge d'or* of soft-planning, bringing comfort and stability to everyone involved.

Nothing like that really emerged and there are now clearly two different sides in the oil industry. On one side is a highly competitive market where international oil companies and landowners—mostly sovereign states—compete for market shares, rents, reserve growth and replacement. On the other side are a few producing states acting as *both* landlords and entrepreneurs, with large, low-cost reserves and a strong short-term interest in preventing price to shrink toward costs. The bigger the first group becomes, the harder the life for the second group. As more and more actors interact in a "state of nature", the task of would-be "social contractors" gets more difficult, and its result more uncertain.

This is the context in which the companies could be invited back to invest in some of the Middle-East countries. There is, as I understand it, only one alternative deserving attention: will those states tend to become mere landowners entering the competitive game, privatising their NOCs and offering acreage to international competitors? Or will the door be only half open, with companies signing agreements that will allow host countries to accomplish their hard task of monitoring the market? The first solution of the alternative would imply a progressive move toward a competitive world oil market, with diminishing rents as price gets closer to costs. The second one would mean a strained status quo. Of course, there are many possibilities between these two, but the underlying logic would be the same. The key question being whether—and to what extent—the competitive process in the world oil market is *constrained* or *emancipated*.

The myth of soft-planning

Hence I find it hard to understand M.A. Tétreault's idea that properly designed arrangements between oil companies and the countries of the Middle East, because they would be "more representative republics", would allow "the survival of competition as a spur to efficiency", while offering "an as-yet-untried avenue toward industry stabilisation in a period of market turmoil." Her concept of "republic of hydrocarbon" as opposed to the "Hobbesian state of nature" the market is supposed to be, is reminiscent of the soft-planning idea—in short: competition is so hard a state to live with that one shall find a way of *rationalising* the market, with common interests prevailing over the pursuit of self-interest.

But is there not here a piece of the "oil mythology" we should be ware of? The historical conditions that gave rise to this idea have passed. The monitoring of the American market during the interwar period took place under the auspices of authorities with

police power and a sovereign federal authority performing a coordination task. (Note that the politics of the *proration* was so suffused with vested interests lobbying and corruption that it had little in common with Tétreault's "Kantian republic", even if it was certainly welcomes by most producers.) The system of the *majors*—the other historical reference of the rationalisation myth—rested on a few conditions that will never be found again: country-wide concessions in all the most favourable areas; joint ownership and management of major production affiliates; vertical and horizontal integration, both financial and operational; partial exemption from antitrust laws in downstream activities, etc—a perfect "social contract" not even sufficient to prevent the eventual emergence of competition.

The market we now live in has so many participants, is so profoundly de-integrated, so marked by globalisation, and so influenced by the liberalisation of oil regimes everywhere in the world, that it is impossible to imagine an alternative to competition as the prime mover of world oil in the decades to come. And in oil like anywhere else, competition is a process by which the economic floor to price is discovered. The question is whether some OPEC governments—probably helped by non-OPEC ones, and perhaps supported by the U.S.—will be able to constrain the development of the competitive process, and to what extent. One can imagine they will. Big oil companies anticipate they will not: would current industry consolidation have occurred if top managers had believed 20 dollars was the rule and 10 dollars an accident?

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The reopening of the Middle East subsoil to private investment, depending on practical modalities, may make little difference with the current situation of the world oil market. But it is difficult to see how it could re-empower OPEC to effectively control the market. It is also hard to imagine how it could be the basis for an alternative to the continuing expansion of the competitive process. The "as-yet-untried avenue toward stabilisation" may finally lead to more competition, hence lower prices.