DANIEL YERGIN

THE PRIZE

THE EPIC QUEST
FOR OIL, MONEY,
AND POWER

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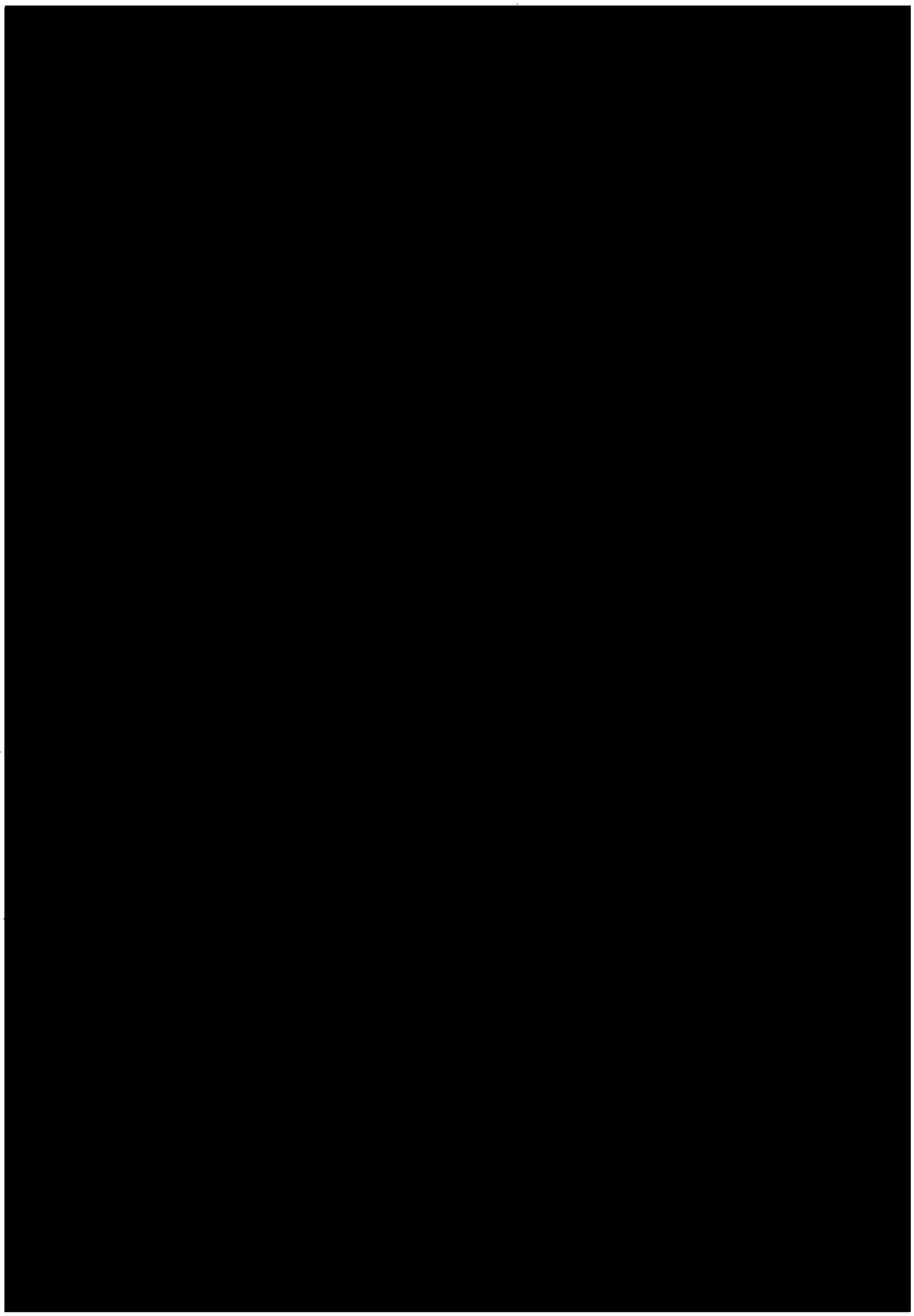

The Mexican Battle

Of all the nationalistic challenges to the oil companies, the greatest came in the Western Hemisphere. There, in one of the world's most important petroleum-activities. The setting was Mexico, and the focal point of dispute was paragraph 4 of Article 27 of the Mexican Constitution of 1917, the clause that declared that underground resources—the "subsoil," as it was called—belonged not to those who owned the property above, but to the Mexican state.

To the companies, of course, that was dangerous dogma. In the years immediately after the adoption of the 1917 constitution, they fought hard against implementation of Article 27, invoking support of the American and British governments along the way. They maintained that the property rights that they had acquired before the revolution, and in which they had invested so heavily, could not retroactively be seized by the state. Mexico insisted that it had owned the subsoil all along, and what the companies possessed did not constitute company property, but only concessions, granted by the fiat of the state. The result was a standoff—in effect, an agreement to disagree.

But the Mexican government did not want to push too far in the late 1920s. It needed the companies to develop and market petroleum. It also, more generally, sought foreign investment to promote the country's "reconstruction;" and driving out the oil companies would hardly have been good advertising. Thus, the Mexican government devised a loose, face-saving formula that kept the companies working but preserved its claim to ownership of the subsoil. This modus vivendi was hardly easy; it was punctuated by periods of sharp acrimony and bitter rhetoric. The tension rose so high in 1927 that a rupture between the Mexican and American governments appeared imminent, with the possibility of another U.S. military intervention, as had occurred when Woodrow Wilson dispatched troops to Mexico during the revolution. The risk seemed real enough to President Plutarco Elías Calles that he ordered General Lázaro Cárdenas, the military commander in the oil zone, to prepare to set the oil fields on fire in the event of a U.S. invasion.

Yet, from 1927 onward, a greater stability and a calming emerged in relations between the oil companies and the Mexican government, and between the two governments themselves. But, by the mid-1930s, that new détente was coming undone. One reason was the economic condition of the industry. Mexico was losing its ability to compete in the world oil market, particularly against Venezuela, because of higher production costs, increasing taxation, and the exhaustion of existing fields. Venezuelan oil was even being landed in Mexico for refining at Tampico because it was cheaper than Mexican oil! The largest foreign oil company was Cowdray's old Mexican Eagle, now partly owned and more or less completely managed by Royal Dutch/Shell. This group was responsible for about 65 percent of Mexico's total production. American companies produced another 30 percent, led by Standard Oil of New Jersey, Sinclair, Cities Service, and Gulf. Rather than risk new investments in the face of the unsettled conditions in the country, most of the companies were simply trying to maintain what they had. As a result, the country's production fell dramatically. In the early 1920s, Mexico had been the world's second-largest producer. A decade later, production had fallen from 499,000 barrels per day to 104,000

higher revenues. It blamed the foreign companies exclusively, rather than acknowledging the effects of a depressed international market and of domestic conditions that were decidedly inhospitable to foreign investment.[10]

The political environment was also changing in Mexico. Revolutionary fervor and nationalism were surging again, and syndicalist trade unions were rapidly growing in membership and power. These changes were personified in the figure of General Lázaro Cárdenas, the former War Minister who became President at the end of 1934. A man of striking appearance, he had, said the British minister, "the long, mask-like face and inscrutable, obsidian eyes of the Indian." The son of an herbalist, Cárdenas had been able to attend school only to the age of eleven, though he remained for the rest of his life a voracious reader of everything from poetry to geography, but especially of history, and more especially the history of the French Revolution and of Mexico. At the age of eighteen, having already worked as a tax collector, a printer's devil, and a jailkeeper, he enlisted in the Mexican Revolution. Recognized for his valor, his self-contained modesty, and his leadership, he was a general by the age of twenty-five and became a protégé of Plutarco Calles, the *jefe máximo,* the "maximum chief" of the revolution. In the 1920s, while other of the new military leaders moved to the right, Cárdenas stayed on the left. As Governor of his home state of Michoacán, he devoted much energy to promoting education and to breaking up large estates in order to give the lands to the Indians. He was sober and puritanical in his own way of life, a supporter of prohibition and an opponent of casinos.

When Cárdenas was elected president, he packed his old mentor General Calles into exile and demonstrated that he was his own man and not a puppet. Adept at playing one group off against another and asserting his own supremacy, he went on to create the political system that would dominate Mexico until the end of the 1980s. Oil and nationalism would prove central to that system. Cárdenas was, in fact, the most radical of any of the Mexican Presidents. "His leftist inclinations make him the bugbear of capitalism," the British minister said of him in 1938, "but all things considered it is to be regretted that there are not more men of his calibre in Mexican life." Cárdenas aggressively pushed land reform, education, and an expensive program of public works. Labor unions became far more powerful during his presidency. He publicly identified himself with the masses and incessantly toured the country, often arriving unannounced to listen to the complaints of the peasants.

To Cárdenas, a fervent nationalist as well as a political radical, the foreign oil industry in Mexico was a painful and sore presence. As military commander in the oil region in the late 1920s, he had developed a considerable dislike for the foreign companies. He resented what he saw as their arrogant attitude and the way that they treated Mexico as "conquered territory"—at least so he was to write in his diary in 1938. And once he assumed the presidency, a shift to radicalism was inevitable. In early 1935, a few months after Cárdenas's inauguration, one of Cowdray's lieutenants in Mexican Eagle complained that "politically the country is quite Red." The oil companies had known how to do business in pre-Cárdenas Mexico, a world of blackmail, bribery, and payoffs, but they were ill-equipped to handle the new realities.

Mexican Eagle itself was caught in a crossfire between its local management, trying to adjust to the new spirit of radicalism in the country, and Royal Dutch/Shell, which had overall managerial control, though only a minority of the stock. Henri Deterding, said the resident manager, "was incapable of conceiving of Mexico as anything but a Colonial Government to which you simply dictated orders." He tried to "disillusion" Deterding. Not only did he fail, but Deterding, in turn, accused him of being "half a Bolshevik." The manager could only fulminate. "The sooner," he said, "that these big international companies learn that in the world of to-day, if they want the oil they have got to pay the price demanded, however unreasonable, the better it will be for them and their shareholders."

Standard Oil of New Jersey was also in no mood to accommodate to the new political realities. Everette DeGolyer, the prominent American geologist who just before World War I had made the huge discovery that was the basis for the "Golden Lane" and the growth of the Mexican oil industry, had maintained his Mexican contacts. Now he was worried by the implacable stance of the American companies. He privately urged Eugene Holman, head of Jersey's production department, to "work out a partnership deal with the Mexican Government which would satisfy their national aspirations and leave the Jersey in a position where it could ultimately retire its capital and, meanwhile, earn a reasonable return upon it." Holman adamantly rejected the idea. "The matter was so important as a precedent in other areas," he told DeGolyer, "that the company would prefer to lose everything that it had in Mexico rather than acquiesce in a partnership which might be regarded as a partial expropriation."

Pressure continued to build against the foreign companies. Indeed, developments in Mexico were but the sharpest expression of a growing confrontation throughout much of Latin America between foreign oil companies and rising nationalism. In 1937, the shaky new military government of Bolivia, anxious to win public support, accused Standard Oil's local subsidiary of tax fraud and confiscated its properties. The action won great applause in Bolivia and attracted much attention throughout Latin America. Meanwhile in Mexico, by 1937 wages had supplanted the chronic debates over taxes, royalties, and the legal status of the oil concessions as the number-one point of contention. The oil workers' union went out on strike in May 1937, with the other unions planning to undertake a general strike in support. Cárdenas was spending much of his time away from Mexico City—in the Yucatán, supervising land distribution to the Indians, and in the small port of Acapulco, where he was overseeing the development of a hotel and bathing beach. But now, with wholesale turmoil threatening, he intervened; the industry could not be closed down, nor a general strike tolerated. Instead, the President set up a commission to review the companies' books and activities.[11]

There was little basis for dialogue. Professor Jesús Silva Herzog, the key member of the review commission, described company officials as "men without

respect who were unaccustomed to speaking the truth." The dislike was mutual. To the British ambassador, Silva Herzog was "a notorious but sincere communist." Silva Herzog's commission declared that the oil companies had been making lucrative profits while raping the Mexican economy and had contributed nothing to the country's broader economic development. It not only recommended much higher wages, pegged at a total annual bill of 26 million pesos, but also called for a host of new benefits: a forty-hour week, up to six weeks' vacation, retirement pensions equivalent to 85 percent of wages at age fifty. The commission also said that all foreign technicians should be replaced by Mexicans within two years.

The companies retorted that the commission had woefully misinterpreted their books and misrepresented their profitability. The total average combined profit of all the companies during the years 1935–37, they claimed, was no more than 23 million pesos, compared to the 26 million pesos in additional wages that were now being demanded. The companies also said that if they were forced to comply with the commission's recommendations, they would have to close down. They were, of course, gambling that the government would not take that chance; they believed that Mexico lacked the personnel, the skills, the transportation facilities, the markets, and the access to capital that would be required in the event of a government takeover.

The companies appealed the commission's recommendations. The government not only confirmed them but also added retroactive penalties. In anticipation of what might happen next, Mexican Eagle evacuated the wives and children of employees. As the charges and countercharges flew, the stakes grew ever higher. The companies feared the establishment of a precedent and model that could threaten their activities around the world. From the beginning, Cárdenas had intended to extend government control over the oil industry. But now, his own personal prestige and power were increasingly engaged. He could not afford to be seen as retreating before the foreign companies; nor could he allow himself to be outflanked by the militant unions on his left. He had to remain in command of an explosive situation. But he was also pulled along by events and circumstances. At one point, he complained to a friend that he was "in the hands of advisers and officials who never tell him the whole truth and rarely give full effect to his instructions." He added that "it was only when he went into things himself that he could ever get at the facts."

Though Mexican Eagle, a British company, was by far the largest producer, much of the agitation against the oil companies was based upon the strong anti–United States sentiment that seemed to unite the country. "The one respect in which I have found Mexicans of all classes completely unanimous," observed an English diplomat, "is their conviction that it is a fixed principle of American policy to prevent the economic development and political consolidation of their country." Yet, ironically, the diplomatic support that the American companies had previously counted on was now a thing of the past. The Roosevelt Administration had adopted a "Good Neighbor" policy toward Latin America, and the New Deal viewed the Mexican government's stance with some empathy. From a foreign policy point of view, Washington was keen to avoid alienating

Mexico at a time when concern for hemispheric defense and fear of an impending war were both beginning to mount. Thus, there was little pressure from the North to counterbalance the unions' radical demands.

The crisis deepened when the Mexican Supreme Court upheld the judgment against the companies. The companies, in turn, upped their wage offers twice, but still not high enough for the union leadership or the Mexican government. On March 8, 1938, Cárdenas met privately with oil company representatives. The result was a further stalemate on the wage issue. Later that same night, Cárdenas, by himself, made up his mind to expropriate—if need be. On March 16, the oil companies were officially declared to be "in rebellion." Even so, Cárdenas continued to negotiate; the two sides were getting closer. The companies finally accepted the 26 million peso wage hike. But they would not budge in their opposition to transferring management decision-making and administrative control to the unions.

On the night of March 18, 1938, Cárdenas met with his Cabinet. He told them that he intended to take over the oil industry. It was better to destroy the oil fields, he said, than let them be an obstacle to national development. At 9:45 P.M., he signed the expropriation order, and then broadcast the momentous news to the nation from the Yellow Room in the presidential palace. His words were greeted with a six-hour parade through Mexico City. The ensuing struggle was to be fierce and drawn out. For Mexico, what had occurred was a great symbolic and passionate act of resistance to foreign control, which would be central to the spirit of nationalism that tied the country together. To the companies, the expropriation was absolutely illegitimate, a violation of clear agreements and formal commitments, a denial of what they had created by risking their capital and energies.[12]

The expropriated companies joined in a united front and tried to negotiate—not about compensation, in which they had no confidence, but to get their properties back. Their efforts were to no avail. But beyond the specifics of Mexico, there was a much graver concern. If the expropriation was seen as succeeding, said one Shell director, "a precedent is established throughout the world, particularly in Latin America, which would jeopardize the whole structure of international trade and the security of foreign investment." Therefore, it was imperative for the companies to respond as vigorously as possible, and they indeed sought to organize embargoes against Mexican oil around the world, charging that such exports were stolen goods. The company that had the most to lose was Mexican Eagle; in addition to being controlled by the Royal Dutch/Shell Group, its stockholders were largely British. The British government took a very strong stand against Mexico. It insisted to the Mexicans that the properties be returned. Instead of replying, Mexico severed diplomatic relations.

A similar break with the United States was only barely averted in the immediate aftermath of the expropriation. Over the next couple of years, Washington tried to exert pressure, primarily economic, on Mexico, but these efforts were half-hearted. In fact, the American companies felt that they were far from getting the support that was appropriate. In the era of Roosevelt's Good Neighbor Policy, and in light of the New Deal's criticism of "economic royalists" and, specifically in the late 1930s, of the oil industry, the American government could hardly act harshly against Mexico or oppose the sovereign right of expropriation so long as what Roosevelt called "fair compensation" was offered. Moreover, with the rapidly deteriorating international situation at the center of his concerns, Roosevelt did not want to further aggravate relations with Mexico, or any other country in the hemisphere, with consequences that could benefit the Axis powers. Cárdenas had judged the balance of world politics correctly.

Washington could already see the unsettling effects from the British-led embargo and the efforts to close off traditional markets to Mexico. Nazi Germany became Mexico's number-one petroleum customer (and at discount prices or on barter terms), with Fascist Italy next. Japan became a major customer as well. Japanese companies were also exploring for oil in Mexico and were discussing the construction of a pipeline from the oil fields across the country to the Pacific. In the view of the Roosevelt Administration, additional American pressure would, perversely, only enable the Axis powers to strengthen their footholds in Mexico.

The much stiffer British position toward Mexico was also driven more by strategic than by commercial considerations. But the strategic issues were seen through a different lens. As outlined by the Oil Board and the Committee of Imperial Defense in May of 1938, Britain's problem was this: Just eight countries accounted for 94 percent of world oil production. The neutrality legislation enacted by the Congress and isolationism in the United States could conceivably foreclose American petroleum to Britain in a crisis. Russian exports had fallen to low levels, and might cease altogether in a war. "The Dutch East Indies, Roumania and Iraq, because of their geographical situation, are regarded as doubtful sources of supply in certain eventualities," said the Oil Board. That left Iran, Venezuela, and Mexico. Yet only a few years earlier, in the clash with Reza Shah, Anglo-Persian had almost lost its treasured Iranian concession.

All of this meant that, in a military crisis, production in the Latin American countries would be essential to Britain, not only "because of their size of production, but because they are favourably placed from a sea transport point of view." Therefore, every effort had to be made "to ensure that the Mexican policy is not followed by other Latin-American countries." London was particularly worried about Venezuela, which was supplying upward of 40 percent of Britain's total petroleum needs. The strategic issues—"defense requirements" and access to oil in wartime—were, the Foreign Office reiterated, "the paramount consideration" driving its entire policy. While the United States was Mexico's neighbor and had many important interests at stake, when it came to oil, Mexico was far more important to Britain than to the United States.[13]

"As Dead as Julius Caesar"

After the outbreak of war in Europe in September 1939, the interests of the expropriated American oil companies and of the United States government diverged even more sharply. As far as the Roosevelt Administration was concerned, national security was much more important than restitution for Standard Oil of New Jersey and the other American companies. Washington did not want Nazi submarines refueling in Mexican ports, nor German "geologists" and "oil technicians" wandering over northern Mexico, near the U.S. border, or in the south, in the direction of the Panama Canal. Indeed, the United States was now busy trying to tie Mexico into a hemispheric defense system. Therefore, it was important to get the oil issue out of the way as quickly as possible. Moreover, in the event of American entry into the war, the U.S. government wanted access to Mexican oil supplies, as had been the case during World War I, and it cared increasingly little about who actually owned those supplies. The expropriation was the major obstacle to cooperation with Mexico, U.S. Ambassador Josephus Daniels told Roosevelt in 1941, and there was no sense trying to restore and defend a status "as dead as Julius Caesar."

The strategic considerations were such that, by the autumn of 1941, shortly before Pearl Harbor, Washington decided to push for a settlement. The crux of the matter by now was certainly not restoration; it was compensation—but how much? Widely differing estimates of the value of the companies' assets in Mexico were broached—from a Mexican figure of $7 million to a company figure of $408 million. The most critical aspect was the value of the subsoil reserves. A joint U.S.–Mexican commission, appointed by the two governments, was charged with developing a compensation scheme; it found a novel and creative solution. It simply came up with the judgment that 90 percent of all the subsoil reserves owned by the companies had already been produced by the time of expropriation! Under this clever formulation, there was no point in arguing further about who actually owned the subsoil or the value of the reserves, since most of the oil was supposedly gone in any event. On that basis, the commission proposed a compensation settlement of about $30 million, spread out over several years.

The companies reacted with bitter outrage at the compensation figure. They argued that they had gone ahead, in the 1920s, to seek out foreign oil supplies partly at the behest of a U.S. government seriously concerned about future security of supply, and now they were being abandoned and betrayed by that same government. But Secretary of State Cordell Hull finally made it clear that, while the companies were under absolutely no obligation to accept the award, neither should they expect any further assistance or support from Washington. The Administration's position was, to put the matter bluntly, take it or leave it, and in October 1943, a year and a half after the valuation had been proposed, the American companies took it.

There was also, however, a price for Mexico. A national oil company, Petróleos Mexicanos, was established, owning almost the entire oil industry in Mexico. But the oil business was no longer export-oriented; its focus shifted to the domestic market and to producing cheap oil as the predominant fuel for Mexico's own economic development. Mexican exports became a small factor in the world's markets. Moreover, the industry was also hamstrung by shortage of capital and lack of access to technology and skills. The insistence on that large wage hike—the "magic figure" of 26 million pesos—had been the *casus belli* of the expropriation of the oil fields. But inescapably, nationalism had to make some concessions to economic reality. In the aftermath of the expropriation, not only was the promised wage hike indefinitely postponed, wages were, in fact, cut.

Britain was in no hurry to effect its own settlement, or even to restore diplomatic relations with Mexico. It still feared that compromise with Mexico would, in the words of Alexander Cadogan, the Permanent Undersecretary of the Foreign Office, "put ideas" into the "heads" of Iran and Venezuela. "Of course, when the war is over that question will assume an entirely different aspect." As it turned out, Mexican Eagle and Shell did not settle with Mexico until 1947, two years after the war's end. In this instance, patience paid off; even considering the fact that Mexican Eagle was the largest foreign company that had operated in Mexico, it won, proportionately, a far better deal than the Americans—$130 million, to be exact.

Mexican Eagle knew, at least, that it had the British government firmly behind it. The American companies, in contrast, believed that they had been grievously wronged not only by Mexico, but also by their own government. On one thing, however, both the British and American companies could agree; the Mexican expropriation was the biggest trauma that the industry had experienced in many years—since the Bolshevik Revolution, perhaps even since the 1911 dissolution of the Standard Oil Trust. For Mexico, the settlements with the foreign companies confirmed the rightness of its course. The 1938 nationalization was seen as one of the greatest triumphs of the revolution. Mexico was the complete master of its oil industry, and Petróleos Mexicanos—Pemex—would emerge as one of the first and most important of the state-owned oil companies in the world. Mexico had, indeed, established a model for the future.[14]