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«Winners and losers. What are the criterias for success?
The upstream industry»

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What Are The Criteria For Success In The Upstream Industry?

We hold to the view that while oil prices may be somewhat more volatile over the next five years on the basis of tighter oil company inventory controls, still, the underlying smoothed trend will be reasonably flat at \$16-\$17 per barrel, or so, for Brent crude, (calculated in real terms). Despite the recent set of coincidental circumstances featuring a particularly cold winter in North America, relatively low world inventories, and delayed expectations concerning Iraq's return to export production, we don't see sufficient evidence to build a case for consistently rising oil prices in an "era of emerging tightness." Such an era may indeed come at some point. But, we are not convinced that we should anticipate it within the period from now to the year 2001.

Why not?

The cost of finding a barrel of crude is still coming down, if only slightly. Application of new technologies should continue to at least hold finding costs even for a time. Other factors might also yield assistance on costs: new, more attractive exploration areas opening up, E & P budgets more efficiently spent via better selection of targets, and continued cost cutting through outsourcing, restructuring and consolidation of producing operations.

Further, OPEC is not as cohesive now as it was several years ago. It is loosening up. Some quota-breaking members are going for market share no matter what the long-term effects may be on the Organization. This is not a particular danger to world oil pricing when circumstances are "helpful," as they are today. But, what happens when they aren't?

We may be coming into such a stage soon. We assume that Iraq will be onstream with some 700,000 barrels a day by September of this year. Our supply and demand model indicates that we are currently close to a perfect balance, with inventories a little bit below normal around the world. With the incremental flows of Iraqi oil, those inventories should move back up to normal levels by the early winter of 1996/1997, and they may begin to become burdensome by the summer of 1997. In addition, there will surely be continued efforts by Iraq to increase its output each quarter under terms of the "humanitarian aid" program.

All of this assumes that OPEC can find the will to hold together under the impact of continued quota breaking by certain members, and that the Saudis will not avail themselves of the temptation to restore discipline in the Organization by deliberately surpassing their 8 million barrel per day quota by 10-15%, thus, bringing prices down sharply. This is a possibility. However, we would still put low odds on its occurrence .

Deregulation and privatization will also play an important role in putting downward pressure on world oil prices through the effects of increased competition, and greater responsiveness of consumers to changes in price and/or the availability of supplies. Many oil companies have operated in "protected circumstances" in their home markets, or in other markets where they have enjoyed a niche position that was difficult to attack. Most of these mini-advantages will be swept away. At the same time, the gradually rising volumes of oil that can be switched (by utilities and industrial customers) to other fuels on the basis of pricing or availability changes will sharpen the previously mentioned effects of competition.

Still, the dominant factor in this discussion remains technology. It stands ready to assist at every turn of the road. The endeavor to find more hydrocarbons at lower cost, to process fuels and transport them to the consumer more cheaply, to obtain more work from each unit of fuel, and to substitute one fuel for another is built on technology, and is driven by the entrepreneurial spirit. The trends we have already seen can only become sharper over time with these kinds of guiding dynamics.

On the other side of the coin, it must be acknowledged that the world demand for oil is picking up, fueled particularly by the emerging country economies. However, the case we would make is that non-OPEC and OPEC supplies of conventional crude seem easily capable of meeting these increases, and more. We also note that demand for natural gas is already outstripping oil in percentage gains and we expect it to continue this trend and take modest market share from oil. Lastly, while many industry observers do not give much credence to assumptions of growth prospects for non conventional crude oil production (from places such as the Athabasca and Orinoco regions), it is my own view that we will be surprised how quickly and economically such supplies become available over the next 5-10 years.

All of the above points on oil pricing are set out to suggest that if oil industry profits are to rise over the next decade, we should not assume that this increase will be the result of higher prices for crude oil. Of course, there could be political/military events such as Desert Storm that create temporary oil shortages, and thus spikes in prices. And, there are weather factors to keep in mind such as was noted last winter in North America. Still, we cannot count on help from these sources. Such special circumstances may occur, but we will not know if, or when, or for how long they may last, until they actually hit.

So, in order to be proactive in our quest for profits rather than reactive, we must concentrate on the two principal sources of profits that roughly fall under our control. These are costs and the capacity to produce incremental volumes of oil and gas. These must be the bedrock elements supporting rising earnings of the oil industry.

We would guess that it will soon be common industry wisdom that cost cutting, restructuring and consolidation have been played out as a means to significantly lift profits. Organizations will have made special efforts to cut costs over a period of years. This is always a painful process. Then company people will say "Thank goodness, that is behind us" (and let us get back to more comfortable ways of operating). But, you are all aware that higher costs are like fat around the tummy. It creeps back unless one is vigilant. So, the fight to trim costs turns out to be not a single revolution, but rather a continuous one. Further, there are always economies of scale that can be found to be useful by combining operations, or breaking them up into new configurations. So, while I would agree with most industry observers that the largest element behind rising profits will be greater volumes of oil and gas produced, leading to top line growth, I still see the cost cutting/restructuring side of the business as playing an important role. Not just now. Indefinitely, I'm afraid.

There are of course many forms of cost cutting/restructuring/consolidating. But, they all lead to the same objective: to reduce the per barrel expense of bringing fuel to the consumer. We will probably see many more joint ventures, "cooperation agreements," consolidations, mergers, and acquisitions. This is not going to make the career life of individuals in the industry any easier. However, it is a necessary consequence of the requirement to keep costs under control. You are

tired of constantly reorganizing your work, your operating unit, your company? I see only more of it on the horizon.

A further aspect of this will be particular deals between service companies and oil companies where oil management will obtain, in effect on long-term contract, those executive and technical skills that have been dissipated over the last ten years by the extreme emphasis on corporate head counts. In certain cases, it seems likely that the major oils will also make deals with smaller independent producing companies, not just for their reserves and land positions but also for the technical skills of their staff and the experience of their top managers. We also expect to see more deals where service company align their interests more closely with those of their clients by taking an equity stake in certain exploration projects as part, or full payment for services rendered.

Not only will the oil companies continue to be "sliced and diced" into new operational units, but, accountability will be carried deep into oil company organizations by the creation of smaller self contained units that allow financial incentives to be targeted to individuals and small groups based on performance standards agreed in advance. Hiring and firing policies are likely to become more severe, with attractive compensation and bonus terms for those meeting or surpassing performance standards, and a quicker exit for those who cannot. As you can see from this description, I do not foresee the days ahead as being much easier than the last decade of trauma we have already been through. Creating added earnings power in an oil company is a hard task.

Of course, the major determinant of an individual oil company's success will be its ability to find increasing amounts of oil and gas at reasonable costs, and the ability to bring these reserves to market quickly and efficiently. This is the core job that has to be done. And there is no getting around the fact that to take this on and pit ourselves against the geological odds, we will have to be more venturesome. This is a polite way of saying that we will have to assume more risk. And that implies that we will have to work harder and smarter at our enterprise in order to make the risk-taking pay off.

How, then, to obtain rising volumes to underwrite top line growth?

Here are ideas on this subject that are circulating through some of the top oil company planning departments today.

- Increase the emphasis on the development of international natural gas (and for transportation systems to bring it to market and/or the power plants to burn it).
- Emphasize the development of non-conventional oil reserves through new technologies (or, put differently, abandon traditional mind sets and recognize an emerging new sector of opportunity).
- Accept greater political risk, where this can be reasonably analyzed, in order to obtain access to geological reserve bases that are known, or believed to exist, in certain difficult jurisdictions (this is risk management in a social form).
- Focus on cutting new deals in areas of large known or potential reserves such as the Gulf or Caspian sectors. Emphasize the enhancement of output rates, or the rehabilitation of older fields, or the durability of production to gain a foothold based on technical, financial, managerial, and “vision” strengths of your organization.
- Consider again exploration areas with previously unattractive physical conditions i.e. lava beds, ice layers, ultra deep oceans, high mountain areas, and so on, through use of new thoughts to solve the problem, and possibly also new tools, equipment, and transportation/drilling modes (this is another facet of risk management).
- Increase efforts to penetrate reserve-rich areas where national oil companies have a present monopoly on operations, but where their long-term lack of success has become a political liability opening the door to shared venturing.
- Continue developing and applying new technologies. Above all other elements, this is the key to future growth. If it is created, or bought, or borrowed, and then used well, technology can produce extraordinary rewards. Companies falling behind the curve of introducing new technologies will surely find increasing difficulty in adding low cost reserves to their base, then in raising new money, and eventually, in maintaining cash flows. Ultimately, in surviving.