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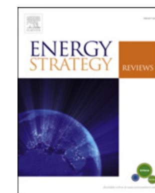

CASE STUDY

International oil companies in the post-studio era: Strategic responses of energy majors to the 2003–2008 price boom

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ABSTRACT

"International oil companies" ("IOCs") have been criticized due to their supposed lack of effort in exploration during the oil price boom of 2003–2008. In particular, they have been accused of concentrating on acquisitions, rather than on "organic development" of their reserve base, jeopardizing the sustainability of their business model. This paper argues that the decision of increasing the focus on acquisitions has been a defensive strategic reaction, and probably the most efficient one, to changing conditions in the competitive environment. The world of hydrocarbons in the last years has been characterized by declining success rate in conventional exploration; declining size of new conventional discoveries; increased assertiveness by producing states; increased need for specific technical knowledge; and overall increase in financial risk and complexity of exploration and production operations. In response, some IOCs switched to a "holding" structure, with a partial outsourcing of exploration tasks, to limit operative complexity and risk.

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1. Introduction

This paper explores the strategic responses of "International oil companies" ("IOCs") to the changing conditions of the oil market in 2003–8, when the price soared to an all-time high of 147 USD per barrel [1]. The critic mostly originated from scholars and the media, whereas financial analysts mostly focused on the short-term performance (as we will review later). In particular, IOCs have been accused of concentrating on acquisitions, rather than on "organic development" of their reserve base (intended as those reserves added as result of exploration activities, addition and revisions), jeopardizing the sustainability of their business model. In this research, I argue that the decision of increasing the focus on acquisitions, rather than on exploration investment, has been a defensive strategic reaction, and probably the most efficient one, to changing conditions in the competitive environment.

In order to investigate the claim, I analyzed the development of the reserves of the seven largest IOCs (BP, Chevron, ConocoPhillips, Eni, Exxon, Shell, Total) with the aim to define whether the additions to reserves have been a result of exploration effort or acquisitions. IOCs have been then broadly ordered into "strategic clusters" depending on their "market" or "traditional" approach. The resilience of these two main strategic options has been tested for the sustainability of their reserves structure and for the financial results during and after the boom (covering the period to 2011). The specific conditions of the market have also been considered: the world of hydrocarbons in the last years has been characterized by declining success rate in conventional exploration; declining size of new conventional discoveries; increased assertiveness by producing states; increased need for specific technical knowledge; and overall increase in financial risk and complexity of exploration and production operations. In response to such dynamics, some IOCs switched to a "holding" structure, with partial outsourcing of exploration tasks, in order to limit operative complexity and reduce risk. This strategic change is comparable to the evolution of Hollywood majors from the "studio" to the "independents" era in the late Fifties, as the movie industry faced declining per movie revenue and increased risk bundled with movie productions, and movie majors reacted by outsourcing productions to smaller, independent companies – similarly to what some IOCs have been doing in the last years through the outsourcing of exploration activities, to face the declining expected revenue per producing asset.

2. Previous research

Concerns about exploration effort by IOCs during the 2003–2008 oil price boom have

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been at the center of a heated debate in the last years. A 2007 paper by Rice University's "James A. Baker III Institute for Public Policy" [2] raised the question whether international oil companies (IOCs) were "sufficiently reinvesting their rising cash flow to find new reserves and increase production [...] since oil majors are not fully replacing their oil reserves and therefore are seemingly slowly liquidating their long-term asset base, implying that they may see a declining rate of production over time" [[2], p. 12]. The authors also observed that "despite high profits and rising oil prices, the largest IOCs have not been able to replace their reserve assets in recent years in contrast to smaller, independent U.S. oil companies and some NOCs [National Oil Companies]" [[2], pp. 12—13]. Also Bridge & Wood [3] claimed that IOCs have been underinvesting in exploration, although oil prices have been rising (a partial explanation was the declining success rate of exploration projects). Osmundsen [1] concentrated on the profitability aspect, claiming that the reduced lack of exploration effort might have been a consequence of focus on short-term financial profitability.

Oil companies reacted with remarkable strategic flexibility in the last forty years, and scholarly research focused on the aspects of restructuring consequent to a constantly changing environment. At the beginning of the 1970s, IOCs were characterized by large size and presence in virtually every producing country in the world. All IOCs were "integrated vertically from initial exploration right through to the retailing of refined products. The central logic here was to limit risk by maximizing self-sufficiency (thus, downstream activities provided the secure outlets for the companies' risky E&P investments). Most intermediate steps were also managed internally: the companies provided most of their oil engineering and oilfield services, and were some of the world's largest shipowners" [[4], p. 304]. Such need for centralized control was due to the fact that "The conventional multidivisional form with its separation of strategic and operational decision making was not feasible for the oil majors because of the close interrelationships, both vertically between their main businesses (exploration, production, refining, and distribution/marketing), and horizontally between their various final products [...]. Rather than operational management being decentralized to the divisions, corporate headquarters were responsible not just for strategic decision making and resource allocation, but also operational planning" [[4], p. 304]. The model could be defined as that of "administrative planning", where the role of the management was that of "optimizing coordination within an essentially closed system" [[4], p. 304]. Market conditions at the time allowed for this form of rigid and simplified business concept. IOCs could rely on reduced volatility of oil prices, and on the control of a large stake on the global oil production — even enjoying the opportunity to engage in "conscious parallelism" business practices.

With the Yom Kippur conflict in 1973 and the rise of OPEC as a functioning cartel, attention switched to the strategic reactions to volatile prices, and on the role that international oil companies played in shaping the political context [5—7]. Grant [8] observed that in the 1970s "the oil companies' world fell apart. The rise in the price of crude oil and the loss of ownership and control of a substantial proportion of the companies' oil properties transformed the strategic position of the companies and made redundant most of the principles that had guided strategy formulation in previous decades. The new environment that the companies faced was one of stagnant oil demand, excess capacity, rapid inflation, unstable exchange rates and interest rates, and aggressive new competitors. The oil companies' strategies became unworkable. Turbulence and unpredictability undermined the economic and market forecasting which had formed the basis of the companies' global and vertical coordination of production and transportation and the long term planning of investment" [[8], p. 51].

As evidenced by Van Lear [9], the first, large wave of mergers in the oil industry developed between 1977 and the second half of the following decade. The reason for the sudden sector shift, which led to 18 reported mergers, acquisitions and stock swaps, was the general "laissez-faire" attitude of the Reagan administration, together with the more specific consideration that "it was less expensive to purchase companies than to make sizeable, more risky investments elsewhere" [[9], p. 149]. In terms of strategies, the option of increasing reserves through acquisitions was due to the need of limiting the impact of swinging oil prices: international oil companies in the eighties were reducing their production to reserves ratio, reportedly in an attempt to line up with OPEC's effort and push up the barrel price.

In particular, exploration was the primary goal of IOCs, as noticed by Grant [10], "During the latter half of the 1970s, upstream investment grew substantially — much of it directed towards the exploitation of the North Sea and Alaska's North Slope. [...] Between 1970—73 and 1975—79, capital expenditure by the companies on exploration and production increased by between 2 and 3 times. The second oil crisis further accelerated upstream investments. In many ways, the rise in oil prices in 1979—80 did more to increase investment in exploration and crude production than did the first oil crisis. While the 1973—74 oil shock was primarily the result of cartel manipulation, the doubling of prices during 1979 was a consequence of the forces of demand and supply [...]. The period 1980—84 was one of unprecedented expenditures on exploration and oilfield investment: upstream investment by the companies annually was at least twice what it had been in 1975—79" [[10], p. 50].

In the 1980s, the concentration was again on the strategic reaction to a volatile context in terms of both price and demand [11], with particular attention on declining profitability [12]. That decade saw drastic changes in the oil industry. The oil market became much more turbulent than before, with unprecedented price swings; moreover, oil demand stagnated until 1986. Oil companies also had to face increased competition within the industry and from alternative energy sources, "most notably natural gas, coal, geothermal power, oilsands and oilshale, and solar power" [[10], p. 31]. The issue of new entrants was in any case the most widely felt, and represented a tendency that started off during the energy crises. So Ghosh & Ghosh [13]: "During the 1970s and continuing into the 1980s, this dominant group lost its preeminence within the oil industry as a result of the expansion of smaller oil companies and the emergence of new entrants. Between 1957 and 1979, U.S. multinational oil companies' share of world oil production fell from 59.8 percent to 16.3 percent. Their share declined further to 6.7 percent in 1982" [[13], p. 34].

The strategy in the period reflected the increased complexity in the industry: Grant [10] observed that "While most of the companies in the industry sought to move towards an increased balance between upstream and downstream activities, the integrated majors moved towards operational separation of their upstream and downstream businesses. The traditional rationale for vertical integration was that companies needed secure sources of supply and secure markets for their production. However, the emergence of competitive, international markets for crude and refined products largely obviated this need" [[10], p. 49]. In general, the two most relevant market changes in the 1980s were represented by increased variability of oil prices (as NYMEX oil future exchanges started in 1983) and by a price slump that conditioned the industry at least until the early 2000s. In terms of industry reactions, three trends could be detected: an increase in industry concentration to ail margins; an increase in reserves to production ratio; and a divestment from refining assets, to concentrate on the core business of exploration and production [9].

By the end of the 1990s, the general tendency of oil majors was towards

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