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COVER STORY

Why You Should Worry About Big Oil

Beyond the fat profits, the giants are surprisingly vulnerable worldwide. That's bad news for business -- and consumers


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You'd think the Apr. 26 oil summit in Qatar would have been an occasion for the industry to celebrate. The world's top energy executives were there, and they could all point to record profits and record demand. But rejoice? John Browne, CEO of London giant BP PLC, ([BP](#)) says instead that the atmosphere was strangely glum. "There wasn't anyone smiling," he says. "They were worrying that the price was too high."


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Browne's comments underscore a surprising point. Big Oil, that clutch of oil and gas giants in the U.S. and Europe, has big problems. Yes, we know it sounds ridiculous. Exxon Mobil Corp. ([XOM](#)) has been reporting the lushest earnings in the history of the business, notching up \$8.4 billion in its latest quarterly report. Combine the forecasted 2006 earnings of BP, Royal Dutch Shell ([RD](#)), Chevron ([CVX](#)), Total ([TOT](#)), ConocoPhillips ([COP](#)), and ExxonMobil, and you get roughly \$135 billion, a sum greater than the gross domestic product of the Czech Republic or Israel. These companies, moreover, enjoy huge political clout in their home

countries, have spotty environmental records, and staunchly defend outrageous prices at the gasoline pump. Why worry about them?

Well, you don't have to love the big oil companies to worry about their ability to provide us with the energy we need. That job is getting difficult, thanks to huge technical challenges, competition from national oil companies, and demanding, even hostile foreign governments. Just look at events in Bolivia on May 1, when the government abruptly nationalized the nation's gas fields.

So the majors may be making billions, but they are struggling to put them safely and soundly to work. Overall production at the oil majors is struggling to keep up with demand, and the reserve replacement ratio, the measurement of how well they are replenishing their supplies, is slipping. A healthy ratio should always be over 100%. But ratios for most of the six oil majors will slip below that level over the next five years, according to Sanford C. Bernstein & Co. "That's nowhere near the rate of reserves needed to satisfy world demand," says Robert E. Gillon, an analyst at oil research firm John S. Herold Inc. While most analysts think oil will hover at its current price, some think that if prices mimic the last big runup between 1970 and 1980, oil could hit almost \$200 a barrel by decade's end, or about \$6 for a gallon of gas. Some options traders are already betting that oil, now around \$72 a barrel, could rise to \$100 by December. Washington consultants PFC Energy figures the world is consuming oil at more than two times the rate of discovery of new supply. Conservation and efficiency gains have already saved billions, but they have not been enough to offset sharply rising demand from China and India.

But even if oil prices were to slump -- and pros like BP's Browne believe that prices could still "turn on a dime" -- the predicament of Big Oil and its customers would persist, since so much of the global oil patch is now off-limits. In theory that shouldn't matter, as long as someone is getting the oil to market. In practice, though, the private oil companies are better than national companies at the technology and innovation that get the best results. Over the long haul, if Big



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Oil can't apply its skills fully, consumers will suffer more than they expect.

A decade ago, in a time of low prices, countries like Russia and Venezuela happily offered good deals to the majors. Now, the big reserve holders figure they can dictate the size of their cut. They are adjusting tax regimes and contracts so that the higher the price climbs, the fatter the percentage that goes to government coffers. Russia and Saudi Arabia are becoming wary of allowing the majors in at all. Gaining access to reserves keeps oil CEOs awake at night. Recent auctions of exploration blocks in Algeria, Libya, and Egypt have yielded terms that many executives believe won't generate returns to compensate for ever-higher risks. "It is becoming increasingly difficult to find attractive ways to reinvest today's profits," says PFC Energy Chairman J. Robinson West.

It won't get any easier. In the 1960s, 85% of known reserves worldwide were fully open to the international oil companies. That number is now 16%. The rest of the world's oil and gas is either restricted or entirely cordoned off. "You don't have an infinite number of prospects to drill anymore," says T. Boone Pickens, the raider and oil patch veteran. In 1979, U.S. and British companies accounted for 27.8% of world oil and gas production. By 2004 their share was just 14%, says Bernard J. Picchi, an analyst at Foresight Research Solutions LLC in New York. National champions such as Saudi Aramco, Kuwait Petroleum, and Mexico's Pemex outweigh publicly traded oil companies in the production contest. "Everyone is pointing their fingers at the ExxonMobils, but they are relatively small players," says Gal Luft, co-director of the Institute for the Analysis of Global Security.

DIFFERENT AGENDA

While the international majors are not the altruistic utilities that U.S. politicians might wish them to be, their main interest is in efficiently extracting and selling oil and gas. Even when they struggle, as Royal Dutch Shell PLC has in Sakhalin in Siberia, the Western oil majors are usually best equipped to tackle the hardest projects. National oil companies, though, often have a different agenda. "More and more production and reserves are controlled by governments or institutions that have more of a political than a commercial motive," says Gerald Kepes, a managing director at PFC Energy. "That has a huge impact on pricing."

The track record of Petróleos de Venezuela (PDVSA), the Venezuelan national oil company, is a striking example. For President Hugo Chávez, PDVSA is a cash cow for social programs, and developing new production is apparently a low priority. Since 1998, just before Chávez took power, PDVSA's output has fallen by 46%. Iran, which has largely excluded foreign companies, has seen capacity fall from 7 million barrels per day before 1979 to below 4 million barrels. These collective shortfalls have driven OPEC'S capacity from more than 38 million barrels a day in 1979 to 32 million, according to Edward L. Morse, a senior analyst at Hetco, an energy trading company in New York. And since many OPEC producers won't divulge vital data, it's impossible to figure out what OPEC's true reserves are.

PERSONNEL SHORTAGE

Given these ever-tighter restrictions, the oil majors are milking the acreage they hold in politically stable zones for all that it's worth. They include the North Sea, the Gulf of Mexico, and the North Slope of Alaska. Discovered in the 1960s and '70s, they are being depleted. As these fields dwindle, their scarcity value as safe zones is shooting up: BP recently sold fields in the Gulf of Mexico to Apache Corp. ([APA](#)) for \$22 a barrel. Two years ago the price might have been around \$7 per barrel.

With the older fields fading, the industry is turning to nonconventional sources like liquefied natural gas and tar sands. "The easy energy is already tackled," says Malcolm Brinded, Shell's executive director for exploration and production. "The industry is going to have to do more and more challenging projects." Shell should know: Its Sakhalin II oil and gas project has reported a cost overrun of \$10 billion.

New strides in technology were supposed to lower the cost of finding these fresh reserves, but the complexity of new ventures adds to the expense. Morgan Stanley figures the costs of finding and developing a barrel have tripled since 1999, to over \$10. Donald L. Paul, Chevron's chief technology officer, notes that offshore wells now often have to drill 10,000 feet or more to find oil: 600 was once the limit. "Wells are \$50 million and up," says Paul. A decade ago, they cost \$10 million.

Companies also say it's not easy finding the personnel needed to man these projects, especially in the West. In

Russia, China, and elsewhere, it's a different story. Russia's Gubkin Institute of Oil & Gas has an enrollment of 8,000 students and adds 1,500 each year -- more than the total native British and U.S. students studying petroleum science, says Joseph A. Stanislaw, senior adviser to Deloitte & Touche's energy practice. The scarcity of people and equipment is delaying projects, putting further pressure on costs and prices. Rigs are being channeled to development projects, which provide quicker profits, rather than pure exploration, possibly diminishing future prospects.

How will the majors respond to these challenges? Seasoned fields like the North Sea are enormously profitable. But as the majors switch to far more expensive fields, returns will drop. The big companies of course have huge resources. ExxonMobil, for example, has \$33 billion in cash, and it has made some promising deals recently. And the majors have a head start if the industry shifts to alternative fuels. But the oil companies are still finding it easier to return billions to shareholders than find sensible new investments. Last year the six majors spent \$71 billion on capital investment, but \$74 billion on share repurchases and dividends.

In the long run, the big oil companies that can't find a way to invest profitably in their industry could find themselves vulnerable. "Companies can't go on returning cash to shareholders. Otherwise they might as well give the assets to someone else," says Mark Bentley, head of global energy investment banking at HSBC ([HBC](#)). Bentley says hedge funds and investors are closely scrutinizing oil company performance. Consumers take note: Big Oil has a future. But despite that gusher of profits, it's not an easy one.

By Stanley Reed, with Christopher Palmeri in Los Angeles, Peter Coy and Rose Brady in New York, and Mark Morrison in Austin, Tex.

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